**FINANCIAL SERVICES COMMISSION**

**COLLECTIVE INVESTMENT SCHEMES AND UNIT TRUSTS**

# FINAL REPORT

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***On behalf of***

***Gowling Lafleur Henderson LLP*** ***MacPherson and Associates***

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# FORWARD

A complete bibliography of the sources we have consulted is provided in Appendix A. To assist readability, we have not provided any footnotes in this report other than for quantitative data, although many portions of the report are the result of a compilation or distillation of information from sources, legislative and other, identified in the bibliography.

However, we would be remiss if we did not acknowledge specifically the seminal 1995 report prepared by Ms. Glorianne Stromberg for the Canadian Securities Administrators, and commonly referred to as the Stromberg Report. We have been greatly assisted by the comprehensiveness of Ms. Stromberg's review. Many of her recommendations have been implemented into Canadian mutual fund regulations, and in many cases we have adopted her reasoning and analysis or taken extracts from her report, with necessary modifications to fit the Jamaican context.

We wish also to acknowledge a report prepared in June 2000 by Stephen I. Erlichman for the Canadian Securities Administrators entitled "Recommendations for a Mutual Fund Governance Regime for Canada". This report contains the most in depth analysis of which we are aware on governance regimes and issues worldwide. Much of the discussion in our chapter on governance is based on a distillation of information extracted from Mr. Erlichman's report, including the list of directors responsibilities contained in Appendix C.

Finally, we wish to acknowledge the usefulness of OSC staff commentary, from which we have borrowed liberally, contained in the companion policy to Ontario's mutual fund regulations. Our discussion and recommendations on the disclosure system reproduce some of Ms. Stromberg's recommendations as well as OSC staff commentary on the implementation of those recommendations.

The Stromberg and Erlichman reports, as well as the OSC companion policies on mutual funds are all available free of charge from the OSC web site at www.osc.gov.on.ca.

Guy David
**September 2001**

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# FINANCIAL SERVICES COMMISSION
# COLLECTIVE INVESTMENT SCHEMES AND UNIT TRUSTS
# FINAL REPORT

## I INTRODUCTION

### 1. Background

The Government of Jamaica (GOJ) is presently in the process of integrating the supervision of the non-bank, non-deposit-taking financial sector, namely the insurance industry, securities, collective investment funds such as unit trusts, mutual funds and other pooled managed accounts, and pension funds. To this end, the GOJ has established the Financial Services Commission (FSC or Commission) as an autonomous, self-funding, regulatory agency combining the functions of the Office of the Superintendent of Insurance (OSI), the Office of the Superintendent of Unit Trusts (OSUT), the Securities Commission (SC) and a new pension fund regulator.

In May 2001, we were engaged by the FSC to advise it in relation to its responsibilities as regulator of collective investment schemes i.e. mutual funds, unit trusts, and other pooled-fund schemes offered by securities dealers, merchant banks and other financial institutions (collectively CISs).

### 2. Terms of Reference

Our terms of reference (TOR) for this consultancy required that we conduct a diagnostic review to make judgments and arrive at conclusions regarding the effectiveness of the current legal and regulatory framework for collective investment schemes and make recommendations for its improvement. We were asked to focus on those aspects that are most relevant to the protection of investors, such as the adherence to high fiduciary standards by CIS sponsors and managers. The TOR required that particular attention be given to the safekeeping of investors' assets and the avoidance of systemic risks. More specifically, the TOR provided that we:

(a). ***Determine the institutional framework:*** Structure of the market; types of collective investment funds offered; investment policy and guidelines; equities, public and private debt; short and long term instruments; repurchase agreements; derivatives (futures, options, swaps, etc.); role of the securities exchange; use of stock exchange and OTC market; major players: independent investment houses and stockbrokers, securities dealers attached to merchant banks or other financial institutions, insurance companies trading on own account; clearance, settlement and custody of listed and unlisted securities.

(b). ***Determine the adequacy of the legal and regulatory framework:*** Coverage of the existing laws on the formation of collective investment schemes; types of institutions permitted to offer collective investment or similar funds; public disclosure requirements; role of trustees; fiduciary obligations of boards of directors or trustees; restrictions on related party transactions; sanctions against unsafe and unsound business practices; treatment of foreign investment; strengths and weaknesses of the domestic legal framework compared to international standards and practices.

(c). ***Determine the adequacy of supervision and control:*** Ability of the FSC to carry out its supervisory and enforcement responsibilities; implications of financial groups on the regulatory environment for CIS and the funds management business; strengths and weakness in terms of autonomy and legal authority to perform their role; self-policing by internal audit or regulatory compliance units; transparency in public disclosure, trading practices, etc.; comment on compliance with IOSCO principles.

## 3. Work Plan and Process

As a first step in this consultancy, we carried out a diagnostic inception mission in Kingston from May 28 to June 8, 2001. The purpose of the mission was to meet with the various public authorities involved in CIS regulation or policy setting, to meet with market participants, private sector advisors and others involved with the CIS industry and to gain an understanding of the events, market forces and strategic forces that are affecting the industry. Copies of relevant laws, regulations and other background information were provided in advance of the mission for preliminary analysis. The focus of the Inception Mission was to:

- assess the legal and regulatory framework for collective investment funds and identify any gaps in the system, taking into account IOSCO best practices;
- review examination and supervision practices and procedures;
- assess the challenges to achieving uniform regulation of collective investment schemes (both for the protection of investors and in order to provide a "level playing field") regardless of whether such CIS are in the form of a mutual fund, unit trust or other investment offered on a pooled fund or portfolio basis;
- review market practices, the various products and risks in the market for collective investment funds and in particular systemic risks arising from market practices and institutional structures; and
- assess existing governance mechanisms having regard to international standards calling for fiduciary requirements to manage and operate funds

for the benefit of investors and for sponsors to avoid self-dealing and conflicts of interest.

The Inception Mission involved extensive consultations with industry participants, their advisors, regulators and policy makers and the stock exchange. These consultations included personal interviews, meetings and a number of follow-up telephone conversations.

It is apparent that the industry recognizes that the results of this consultancy will be largely dependent upon the quality of their input. People made a real commitment in time and resources to meet with us and provide all follow-up information that was requested. We wish to acknowledge and express our thanks for the very useful and insightful input that was provided by the many industry participants who took the time to meet with us.

During the two weeks of the Inception Mission, we participated in approximately 12 industry meetings, covering both unit trusts and securities dealers. This provided a first hand view of the industry's perspective. Our task in formatting recommendations has been made easier by the fact that there appears to be remarkable consensus as to the issues and what should be done. Hopefully, this report will further advance the process in achieving these improvements. Our Inception Mission Report was carefully reviewed by regulators and copies were delivered to the industry for their input and consideration. Prior to arriving at our final recommendations contained in this report, we sought feedback from the industry on the findings contained in our Inception Mission Report. We also consulted further with the FSC by way of telephone and email exchanges.

Our task has been greatly assisted by the insights provided by the regulators and government officials with whom we met. In all, we held over 10 meetings with regulators and other government officials involved in various aspects of collective investment regulation and policy. All were very forthcoming in presenting their views candidly and in a manner that ensured that we gained as clear as possible an understanding of the institutional context, evolution and future direction of the economy and regulatory framework, and this despite the short time available to us to conduct the diagnostic part of our mandate in Jamaica,

We would like to specifically acknowledge the invaluable support and preparatory work provided by the staffs of the FSC, SC, Finsac and OSUT. All showed a real dedication to advancing the process and doing what they could to ensure a successful consultancy. In particular, we wish to thank Brian Wynter (FSC) and Erica Anderson (Finsac). Mr. Wynter provided guidance at all stages of the consultancy. Ms. Anderson attended most meetings during the Inception Mission, provided useful information on local conditions and ensured that our time in Jamaica was spent as productively as possible.

Annex A provides a list of documents reviewed prior to and during the Inception Mission, or in the course of preparing this report. Annex B provides a summary overview of meetings held during the Inception Mission.

## 4. Our Approach

As a result of our findings during the Inception Mission and consistent with our Terms of Reference, we approached this assignment from the perspective that:

1. what is good for the investor is good for the industry and will foster efficient and competitive capital markets;

2. the "industry" should include all aspects of money management on a pooled fund or common portfolio basis;

3. the foundations of the industry must be integrity and trust;

4. the concept of "buyer beware" cannot by itself govern the activities that result in individuals investing their money in investment funds; there is a need to have safeguards in place to ensure that the system operates fairly, openly and in the interests of investors;

5. there is a need for better regulation and more responsive regulators rather than more regulation;

6. within this environment, the regulatory strategy should be to allow competitive forces to operate with minimal intervention.

## 5. Challenging Issues

The major areas that present challenges in the present state of the market for collective investments include:

- Defining the scope of CIS regulation- what should be in/what is ok to be exempt, should constant value money market funds be permitted

- Developing appropriate governance mechanisms and requirements

- Conflict of interest concerns having regard to the emergence of financial groups

- Custodianship issues

- The absence of a self-regulatory organisation for the investment industry and the heretofore limited resources of the regulators to monitor and enforce compliance

- A drastic increase in demand for securities over intermediated financial products with the result that much more risk is being assumed directly by investors, instead of by financial institutions that are subject to prudential norms

- The lack of comparability of information about collective investment products

- The need to increase investor awareness and understanding of issues.

Our diagnostic review and recommendations in this report are intended to assist the FSC and the industry in addressing these areas of concern and thereby meeting the expectations of the investing public and gaining their confidence. Our major proposals which support the more detailed recommendations discussed in this report include:

- A comprehensive definition of "collective investment" which would encompass many money market investments that are presently offered as exempt, with special rules to allow pure money market funds meeting defined criteria to continue to operate on a constant value basis. The regulatory scheme should include unit trusts as well as closed-end funds, but should preserve the "brand" identity enjoyed by unit trusts;

- The imposition of fund governance arrangements for all funds, but flexibility as to alternative forms of fund governance; self-dealing rules within financial groups to maintain a level playing field;

- Flexibility as to the permitted form of a collective investment fund i.e. contractual trust, corporate form, unit trust or other;

- Continuation of custodianship requirements, but flexibility with regard to independence for schemes other than unit trusts; and less onerous custody requirements for book-based securities to encourage development of a book-based system for debt securities;

- Integrating primary and secondary disclosure requirements, ensuring that information is relevant and understandable, and re-focusing much of the mandatory disclosure from the regulator to the investor

- Adopting a portfolio risk approach to fund investment policies, and mandating a standardized approach to performance information to allow investors to compare funds;

- Providing incentives for the development of an investment industry SRO and for the development of a book-based system for debt securities.

The desired outcomes of these recommendations would be to:

(a) ensure that all collective investments are encompassed by the regulatory scheme;
(b) provide a risk-based approach to supervision and oversight of sponsors and managers, and lessen the burden of examination and inspection of specific funds by the regulator;
(c) better adapt the existing regulations to local conditions;
(d) increase transparency and raise public awareness;
(e) establish high standards of governance for sponsors and managers; and
(f) maintain the flexibility that currently exists for the development of new capital markets products.

### 6. The Need for Follow-up Work

It is our expectation that the recommendations contained in this report will be further developed by the industry and the FSC and (to some extent) the BOJ, as appropriate, before being implemented by the FSC. These recommendations are intended to serve as the starting point for this undertaking. Further work may well result in approaches that we have not considered, or better ideas than those presented here. Participation in this follow-up work by all concerned would, in our view, contribute to the development of a regulatory scheme best suited to the Jamaican environment. We do not presume to have all the answers to the challenges noted above.

## II CAPITAL MARKET STRUCTURE

### 1. Capital Market Instruments

The island's capital market consists of (i) the Jamaican Stock Exchange (JSE) which operates a fully automated market for listed shares and corporate bonds; (ii) an over-the-counter (OTC) money market in short-term commercial paper issued by private issuers; (iii) an OTC market in government debt instruments (money market) and (iv) the foreign exchange market.

***Equities.*** The equities market has just started to pick up after having been in decline for a number of years. Most listed stocks are still thinly traded and the market is illiquid by international standards. Listed securities are traded electronically on an automated trading platform administered by JSE and the Jamaica Central Securities Depository (JCSD), which is owned and operated by the JSE. Market capitalization as at December 31, 2000 was approximately J$160 billion up from approximately J$104 billion a year earlier. Of the J$56 billion increase over the period, J$22 billion represents new issues. It is estimated that approximately 10% to 12% of listed issues are held by CISs (J$16-18 billion in value at December 31, 2000) - mainly unit trusts. It is

estimated that dealer retail accounts might bring the total retail holdings of investors to approximately 20% of the market.[1]

Despite its lack of liquidity, the JSE appears to function quite effectively as a self-regulatory organisation (SRO) governing the activities of its 6 member brokers. Its by-laws contain a number of rules for listed securities and member brokers that enhance significantly the regulatory regime applicable to both primary distribution and secondary trading of listed securities.

***Commercial Paper and Participations.*** The introduction of commercial paper to the capital markets is a relatively recent phenomenon prompted by high commercial bank interest rates. Regulations under the *Securities Act* establishing disclosure requirements for primary distribution of commercial paper were adopted in 1999, but have been criticized by the industry as lacking sufficient flexibility to accommodate the needs of a volatile market. It is estimated that the volume of commercial paper in circulation is somewhere around J$7 billion, having declined somewhat since the introduction of the regulatory requirements. CP holdings in managed accounts were J$5.3 billion at September 30, 2000[2]. As an alternative to CP, issuers have recently been turning to commercial bank initiated loans that are participated out (sold) to securities dealers for inclusion in their pooled-fund portfolios on either a fully-guaranteed or non-recourse basis. The amount of such "certificates of participation" in managed accounts at September 30, 2000 was J$14 billion.[3]

***Money Market.*** The money market includes treasury bills, medium term coupon bond type instruments called local registered stock (LRS) and GOJ debentures with maturities from two to ten years. The total value of securities issued as at December 31, 2000 (exclusive of BOJ repurchase agreements) was J$277.5 billion made up as follows:

| | | |
|---|---|---|
| Treasury bills | - | 7.6 billion |
| Local Registered Stock | - | 134.0 billion |
| Finsac Notes | - | 90 billion |
| GOJ Debentures | - | 41.7 billion[4] |
| Locally-issued USD Notes | - | 9.7 billion |
| Locally-issued J$ USD-indexed bonds | - | 7.6 billion |

The total amount of money market instruments held in managed accounts at September 30, 2000 was approximately J$144 billion. By comparison, retail

[1] Estimate provided by Wain Iton, General Manager of JSE.
[2] " Preliminary Funds Under Management": Report of the Securities Commission, as at September 30, 2000
[3] Securities Commission- see Note 2.
[4] Jamaica Economic and Social Survey, 2000- The Planning Institute of Jamaica; Securities Commission

deposits by individuals in commercial banks as at December 31, 2000 totalled approximately J$80 billion.[5]

## 2. Importance of the Investment Fund Industry

The investment fund industry is very important to the Jamaican economy and to the investing public- much more so than the equity markets. For the Jamaican economy, the investment fund industry provides one of the major sources of financing of government debt. For investors, the industry provides an attractive alternative to low interest deposits in commercial banks and to the more speculative nature of direct equity investment. More and more "savers" are turning to collective investment schemes and managed accounts as a means of protecting and maximizing the value of their savings. Industry participants point out that the main factors attracting individuals to money market funds are a desire to keep investments liquid and short term, and a perception of security of funds invested in government securities.

## 3. Rapid Growth of Investment Fund Industry

The investment fund industry has undergone phenomenal growth in the last ten years, with most of the growth occurring since 1996. Most of this growth has been fuelled by the emergence of money market funds. By way of illustration, at the end of 1996, the amount of unit trust assets was approximately J$10 billion and with the exception of one money market fund which commenced in 1992, the securities dealers were just starting to offer pooled funds.[6] By September 2000 the amount of CIS and assets under management by unit trusts and licensed securities dealers had increased to at least J$180 billion.[7] Inflation appears to account for only a small portion of this growth. As a percentage of GDP, the amount invested in collective investments increased from less than 5% in 1996 to more than 60% in 2000.

These assets were divided among 8 unit trusts and an estimated 35-40 dealer funds. Industry leaders estimate that the ten largest of these companies account for over 75% of managed funds, with the top three accounting for about 40% of the market The table below provides an estimated breakdown of the placement of individual savings and business accounts in the various instruments available in the Jamaican financial market.

[5] Bank of Jamaica Digest- March 2001, Table 11
[6] Superintendent of Unit Trusts and various industry sources
[7] Estimate- Securities Commission

**BREAKDOWN OF RETAIL SAVINGS BY TYPE OF INVESTMENT**

(December 31,2000- J$ 000's)

| | |
|---|---|
| Deposits in financial institutions | $106,600,000.[8] |
| Equity securities (pooled funds) | $ 16,000,000[9] |
| Managed Funds | $164,000,000[10] |
| **Total** | **$286,600,000** |

It is apparent that a shift away from intermediated financial services and into securities is taking place. This is evidenced by the growth of the commercial paper market, dealer-sponsored non-recourse loan participations and of course the rapid expansion of the money market. As a result, significantly more risk is being borne directly by individual investors.

While this evidences a dynamic, competitive and innovative financial market, it brings with it the need for market conduct regulation of those involved in the distribution of these securities to provide investors with an appropriate level of protection.

## 4. Structure of the CIS Industry

The CIS industry is made up of 8 unit trusts managed by four management companies and a number of fixed or guaranteed income funds offered by securities dealers, merchant banks, insurance companies and commercial banks. Until recently, the unit trust companies were supervised by the OSUT under the *Unit Trusts Act*. With recent changes in legislation, unit trust management companies as well as all other institutions that deal in securities will be required to be licensed under the *Securities Act.* The dealer-managed funds (which to date have not been regulated *per* se) represent by far the largest segment of the market both in terms of value of funds under management and number of account holders.

***Industry Participants.*** The primary CIS industry participants are unit trust management companies, licensed securities dealers, merchant banks, insurance companies and commercial banks. However, affiliations and financial groups within the industry result in a number of different regulatory and supervisory combinations, such as:

- unit trust management companies which until recently were not required to be licensed securities dealers and were subject only to OSUT supervision;
- securities dealers offering fixed or guaranteed income funds, and which are subject to SC supervision;

[8] Bank of Jamaica Digest- March 31, 2001, Table 11
[9] Estimate- 10% of market capitalization at December 31, 2000
[10] Securities Commission.

- unit trust management companies affiliated with securities dealers, which have been subject to both OSUT and SC oversight;

- securities dealers affiliated with merchant banks- and in some cases also with a unit trust management company, which were subject to OSUT and SC oversight (now FSC) as well as BOJ oversight; and

- merchant banks which hold a financial institution license but are not licensed as securities dealers and thus are subject only to BOJ oversight.

***Unit Trusts.*** The first unit trusts began operations in the early 1970's. Enabling legislation based on the UK *Unit Trusts Act* was adopted in 1971 to permit the establishment of these funds. The funds have continued to grow despite investor losses in equity funds experienced during the 1990's and more recently, substantial devaluation of real estate-based funds. However, the growth of unit trusts has not nearly kept pace with investor demand for pooled managed funds, and today the unit trusts are far surpassed in importance by the money market funds.

Factors which have contributed to the relative decline of unit trusts include:

1. investor wariness of medium term investments in a recently unstable economy and inflationary market;
2. investor wariness of equity investment as a result of significant downward movement of equities in the latter half of the 1990's;
3. high rates of return and perceived security available in money market funds invested principally in GOJ securities;
4. bad publicity resulting from serious problems in two groups of unit trusts where investor losses were averted principally by reason of government intervention (JUTS) or takeover by a new management company (Eagle); and
5. the regulatory moratorium imposed in early 1997 on changes to unit trusts.

***Money Market Funds.*** The money market funds and managed accounts began in or about 1993 following the passage of the *Securities Act* and the licensing of securities dealers under that Act. They have grown very rapidly for the various reasons outlined above. A further contributing factor to this growth has undoubtedly been the practical lack of regulatory constraints on the establishment of funds and their management. However, as the industry now reaches a new stage of maturity, it is recognised almost uniformly that institutional adjustments are required in order to protect both the industry and the investors on which it depends.

Fund offerings appear to be both "on balance sheet"- even in the case of certain securities dealers, and "off balance sheet"- even in the case of certain merchant banks. However, there appears to be an awareness among securities dealers

that pooled funds should be strictly offered on an off balance sheet basis, in keeping with representations to the public that they are investing in government securities and not in the securities dealer itself. There is also an awareness (at least among some merchant banks) that off balance sheet activities should be segregated from licensed financial institution activities. Obviously, capitalization is a major consideration for institutions conducting both deposit-taking and securities business in the same corporate entity. Existing regulatory enactments and supervisory policies do not require formal separation between banking and securities activities.[11]

A recent trend in the industry has been the coming together of merchant banks with securities dealers, either through merger, takeover or other combination. The market forces underlying this phenomenon would appear to be- on the one hand, a desire on the part of the merchant banks to enter the lucrative and growing fund management business - and on the other hand, the opportunity for the securities dealers to gain access to the merchant banks depositor/client base for their managed fund offerings. The segregation of banking and securities business and specific rules governing on-balance-sheet and off-balance-sheet activities should be a priority for both banking and securities regulators.
Sales and distribution practices, as presently employed, do not pose any regulatory challenges or concerns. Most sales are effected directly by the dealer or fund in question via licensed representatives. However, as discussed below, there is a need to improve the disclosure system, particularly at the point of sale, and there may be some administrative practices such as commingling of funds that should be curtailed.

## 5. The Need for Self-Regulation

Other than the JSE, which has only six broker members and is concerned primarily with the equity market, the securities industry does not have an industry association or self-regulatory organisation. We believe it would be very desirable for such an association to be organised as soon as possible. This association would be limited to licensed securities dealers, including the securities affiliates of other financial institutions. It would develop rules, regulations and trading practices for its members, which should be subject to approval by the FSC. Among other things, this FSC oversight would ensure that the interests of investors were paramount in the development of these rules and that the rules served to make the markets more secure and its participants more efficient, without creating distortions that could lessen competition. This organisation could eventually become a mandatory SRO for the industry, thereby adding significantly to the over-all regulatory and supervisory structure.

Some of the matters over which the SRO might assume primary responsibility might include

[11] It is expected that such formal separation will soon be required as a result of recent BOJ pronouncements.

- proficiency requirements for investment advisors
- clearing, settlement and back-office procedures for dealers
- public education about the industry
- procedures for prevention of fraud
- arrangements between dealers to detect money laundering
- developing a code of ethics and business conduct for the industry

In our recommendations, we recommend dispensation of the custodianship requirement for booked-based securities carried by a manager who is a member of a book-based system and an industry SRO. Other incentives for the industry to create an SRO could include lighter regulatory fees for SRO members, broader powers or dispensations (such as above), and other measures that would allow members to operate at lower cost or with less regulatory oversight than non-members. While some jurisdictions make SRO membership mandatory, this can be controversial and is not recommended at this time.

## III LEGAL AND REGULATORY FRAMEWORK

### 1. Financial Services Commission Act

The *Financial Services Commission Act, 2001* (FSC Act) was passed in March 2001. The Act confers on the FSC a mandate and related powers which are consistent with the highest international standards of securities regulation and supervision.

The FSC Act establishes a semi-autonomous commission with the power to regulate and supervise institutions that offer prescribed financial services to the public. Prescribed financial services include i) trading in securities (including unit trusts); ii) insurance; and iii) such other services as are prescribed by Ministerial order. The FSC succeeds and replaces the Securities Commission. Its object is to protect customers of financial services, and in so doing, it has the duty and power to:

- Supervise and regulate prescribed financial institutions
- Promote risk management procedures and controls for financial institutions
- Promote stability and public confidence in the operations of such institutions

- Promote public understanding of the operations of such institutions

- Promote the modernization of financial services, with a view to the adoption and maintenance of international standards of competence, efficiency and competitiveness.

The Commission is required to inspect every prescribed financial institution at least annually to verify soundness and compliance with applicable legislation, and to take such steps as to ensure that appropriate standards of conduct and performance are being maintained by institutions under its jurisdiction. It has broad powers of intervention and enforcement, including the power to obtain undertakings from the directors of institutions, give directions and issue cease and desist orders. The Commission has broad rule-making powers to regulate institutions and the financial markets.

The Commission is semi-autonomous of Government. While certain of its administrative arrangements are subject to Ministerial approval and the Minister has the power (after consultation) to give general policy directions on matters concerning public interest to the Commission, the FSC is intended to operate at arms length from Government. The Act empowers (but does not require) the Commission to be self-funding, although this is the expressed policy of the Government. Until the Commission becomes completely self-funding, the performance of its mandate may be limited by the amount of annual Parliamentary appropriations it receives.

In the area of transparency, which is a hallmark of many developed capital markets, the FSC Act could more clearly articulate fundamental principles. There is a requirement in the Act for advance public consultation on regulations adopted by the Commission but selective consultation is permitted i.e. "*with such providers of financial services as it thinks fit*". The legislation specifically identifies fees and charges as being subject to this process. In practice, the Commission has consulted the industry widely on a number of initiatives. However, a clear statement as to how the Commission will meet this requirement could and should be included in the Commission's own procedures once they are adopted.

The FSC Act includes obligations of secrecy on the part its staff, which are enforceable by penal sanctions. These secrecy provisions are similar to those typically found in banking legislation.

At first view, it is not clear whether the FSC has the power to simply make decisions to disclose information where it determines that it is in the public interest to do so, or whether it is bound by the secrecy provisions that apply to its staff. There may also be some conflict between the *FSC Act* and the *Securities A*ct. For example, the *Securities Act* empowers the Commission to make public statements, as it thinks fit, in relation to investigations which have been or are

being conducted. Presumably this power will continue once the FSC becomes successor to the SC. In any case, it would be desirable for the FSC to establish clear policies at an early stage regarding public disclosure and to monitor those policies on a continuous basis.

A further consideration in relation to secrecy relates to the ability of FSC to engage in international sharing of information and cooperation with securities regulators in other jurisdictions. It is not clear to what extent this is permitted in the existing legislation. It seems to be authorized by the *Securities Act* but possibly contrary to the *FSC Act.* Further clarification would be useful.

The Commission does not expect that the secrecy provisions will impede its ability to operate in an open manner as regards administration and enforcement of the legislation for which it is responsible. It has indicated that it sees a need for the secrecy provisions because of prudential requirements for certain regulated entities. This is a problem inherent in combining *prudential supervision* (for insurance companies) and *market conduct supervision* (for securities dealers) in the same body. The FSC is aware of the need for early and continuous attention to ensure that its supervisory activities in relation to securities are conducted as openly as possible.

## 2. The Securities Act

The *Securities Act* was adopted in 1993 and was subsequently amended in 1996, 1999 and 2001. The original Act established the Securities Commission and conferred upon it broad powers to regulate secondary markets in securities and brokers and dealers in securities. The 1996 amendments brought about certain technical improvements to the Act, and also introduced a definition of "mutual fund" and a requirement for mutual funds to comply with regulations made under the Act.

The 1999 amendments enabled the establishment of central securities depositories subject to approval and supervision by the SC. The 2001 amendments transferred the responsibilities of the SC to the FSC, harmonized the Act with the FSC Act, and widened the ambit of the Act to include a number of additional matters. The principal new matters added to the *Securities Act* in 2001 are:

- the power to regulate primary distributions;
- the expansion of the definition of "mutual fund" to include virtually any pooled fund arrangement which confers on the investor a right of redemption or repurchase, or any other arrangement prescribed by ministerial order;
- a requirement for dealers to report on offshore investments made by them on behalf of clients; and

- a requirement for dealers to have audit committees and conduct review committees.

Comprehensive regulations have been adopted under the *Securities Act* to deal with a number of matters that are not provided for in detail in the principal Act. These include: periodic and continuous disclosure requirements for issuers which are generally consistent with international standards; registration and disclosure requirements for commercial paper offerings; pre-notification requirements for mergers between licensees; "know your client", suitability and fair dealing requirements for licensees with respect to their customers; record keeping and segregation of funds and accounts consistent with international standards; and mandatory compliance committees for licensees. Additional regulations have also been adopted to regulate the Central Securities Depository, takeover bids and mutual funds.

As a scheme of market conduct regulation, the *Securities Act*, with its various amendments and regulations provides a relatively comprehensive scheme of regulation and supervision for those dealing in securities. However, the absence of comprehensive regulation of primary distributions of securities until very recently allowed the development of several types of securities products (including collective investments) that have been issued on an unregulated basis.

## 3. <u>The Mutual Funds Regulations</u>

The *Securities (Mutual Funds) Regulations, 1999* (MFR) provide a relatively comprehensive scheme for the regulation of corporate form mutual funds in a manner that is generally consistent with international standards.

This regulation

- Provides for the registration of mutual funds and conditions of registration

- Establishes mandatory custodianship requirements for local mutual funds and requires that the custodian be a bank or other licensed financial institution, and that it be legally independent of the fund manager

- Specifies the duties of the custodian in relation to the fund

- Establishes capital requirements for mutual fund managers and restricts their business activities "primarily" to mutual fund management

- Establishes disclosure requirements

- Prescribes audit and record keeping requirements for mutual funds
- Provides for annual or special inspection by the FSC
- Establishes portfolio requirements and concentration limitations
- Establishes penalties for non-compliance

The MFR also provide for the registration of foreign mutual funds in Jamaica and for investment by Jamaican mutual funds in foreign assets. Unit trusts are presently exempted from the MFR because of the existence of their own regulatory scheme under the *Unit Trusts Act.*

## 4. The Unit Trusts Act

The *Unit Trusts Act* (UTA) was adopted in 1971. It was based on similar legislation then in force in the UK, and until very recently it remained largely unchanged since originally adopted. Recent amendments passed in March, 2001 have added the concepts of "fit and proper persons" for management company directors and sales persons, strengthened audit requirements, transferred supervisory responsibility from the Superintendent of Insurance to the FSC, harmonized the Act with the FSC Act, and transferred regulation-making power from the Minister of Finance and Planning to the FSC, subject to the approval of these regulations by the Minister.

The UTA (as amended) provides for the creation of collective investment schemes by way of formal trust deed (unit trust), managed by a management company, and vested in a trustee who must be legally and functionally independent of the management company. The Act prohibits anyone from offering pooled investments on a trust basis ie. to investors who will *"obtain beneficial interests or rights under a trust"* other than by way of a unit trust registered under the Act. Pension arrangements are exempted from this prohibition. Sales persons of registered unit trusts must also be employed either by the manager of a registered unit trust, or by a bank, insurance company, securities dealer or an institution approved by the Minister, that in each case has adequate arrangements for training of its sales persons.

The UTA provides generally for the registration of unit trust schemes, the registration of sales persons, the content of trust deeds, inspections, record keeping, audit, disclosure to investors and offences for breach of the Act. The Act contains broad regulation making powers as well as broad discretion permitting the supervisor to make determinations of the public interest in relation to the registration of schemes under the Act. Under the *Unit Trusts Act,* there is a provision requiring salespersons to be licensed but it was never proclaimed. In the case of at least one management company, sales commissions are paid to

commercial banks where their facilities are used to sell units in a unit trust scheme. As a result of an amendment to the *Securities Act* in March 2001, managers of unit trusts are now required to be registered as dealers under the *Securities Act*.

## 5. Observations on Legal Framework

As between the legal framework for unit trusts and mutual funds there exists a relatively comprehensive (although somewhat confusing) scheme of CIS regulation. The legal definitions are sufficiently broad to catch most pooled fund offerings either as unit trusts or mutual funds. Nevertheless, the bulk of pooled fund offerings take the form of managed accounts provided by licensed securities dealers (including financial institutions) that are not unit trusts and to date, have not been regulated as mutual funds under the *Securities Act*. This is probably a result of the fact that the definition of "mutual fund" under the *Securities Act* has just recently been broadened, and before the latest amendment, there existed a fairly significant gap which allowed dealers and financial institutions to offer pooled fund investments on a largely unregulated basis because they were neither units of a trust nor shares of a mutual fund. Moreover, the MFR still only contemplate corporate form mutual funds, which may add to the confusion as to the scope of the expanded definition recently added to the *Securities Act.*

The existence of separate mutual fund and unit trust legislation (the result of historical circumstance rather than design) adds unnecessary complexity to the regulatory framework without serving any useful purpose. The expansion of the definition of "mutual fund" under the *Securities Act* has made the existence of separate unit trust legislation unnecessary. A unit trust is simply one of a number of forms that a CIS can take. Accordingly, it would be desirable to repeal the UTA and bring unit trusts under the MFR. This need not result in unit trusts losing their own particular characteristics or "brand" identity as such, but rather would simply cause them to be subject to the same overall regulatory scheme as other pooled funds.

This approach would be consistent with market practice in several jurisdictions which allow alternative forms of CIS vehicles under the same regulatory scheme. The only requirement of the IOSCO Principles that must be observed in this respect is to ensure that the legal form and structure of funds provides certainty to investors in assessing their interests and distinguishing the CIS pool from the assets of other entities. The regime must place limits on or regulate the use of different types of securities that have differing claims on the assets of a CIS. This can easily be provided for in the mutual fund regulation by defining the fundamental rights of investors, which would not vary from scheme to scheme, regardless of its legal form.

In order to move forward on this basis, we would recommend that

- The *Unit Trusts Act* be repealed in order to bring all pooled investment funds under the same set of regulations, thereby simplifying the system and providing a more level playing field

- The *Securities Act (Mutual Funds) Regulations, 1999* be reviewed and revised in order to extend them to all collective investment funds and better adapt them to local market conditions

- The FSC engage in public consultation on the proposed regime before it is implemented in order to become aware of and respond to market concerns.

## IV SUPERVISION AND CONTROL

### 1. Overview of Responsibilities

Regulatory responsibility for the financial markets in Jamaica is divided between the BOJ and the FSC. Commercial banks and merchant banks, as deposit-taking institutions, are licensed, supervised and regulated by the BOJ. The FSC Act empowers the FSC to license, regulate and supervise insurance companies and all institutions that deal in securities, including units of a unit trust.

Securities dealers (including any licensed financial institutions that engage in securities dealings other than on their own account) are required to be licensed as securities dealers or investment advisors under the *Securities Act.* This would include merchant banks and commercial banks. All licensed securities dealers are subject to regulation and supervision by the FSC, including licensed financial institutions subject to BOJ supervision. Moreover, the FSC Act also gives the Commission regulatory responsibility for any institution that provides services in connection with trading in securities.

The *Securities Act* and the *Securities (Mutual Funds) Regulations, 1999* require virtually all collective investment schemes, other than registered unit trusts, pension funds and certain insurance funds, to be registered as mutual funds under the Act and regulations, and the managers of such funds (including unit trust managers) to be licensed securities dealers. The FSC Act effectively confers regulatory responsibility on the FSC over the managers, trustees, advisors and sponsors of virtually any collective investment scheme.

We have not examined the adequacy of the supervisory framework for deposit-taking institutions within the scope of this consultancy. However, we have received ample anecdotal evidence to the effect that the scheme is comprehensive and consistent with international standards, and that the BOJ conducts regular inspections of institutions under its jurisdiction and monitors

market practises of these institutions. Thus, despite the dual supervision and regulation of deposit-taking institutions that also deal in securities, there are unlikely to be any gaps in the regulatory framework, and more likely there is overlap.

## 2. Consistency of Supervisory Framework with IOSCO Principles

The powers of supervision and control vested in the FSC under its own enabling legislation and under the *Securities Act* and its regulations are consistent with international standards, and are sufficiently broad for it to exercise adequate oversight over the licensees under its control.

The most widely accepted statement of international standards for CIS supervision and regulation is as set out in the *Principles for the Regulation of Collective Investment Schemes* established in the 1994 Report on Investment Management published by the Technical Committee of IOSCO (the IOSCO Principles). As regards the supervisory framework these principles require that the regulatory regime provide:

- A regulatory authority must take overall responsibility for the supervision of CIS authorized within its jurisdiction
- A CIS must be registered and/or authorized by the regulatory authority before commencing to market its units
- The regulatory authority must have the power to investigate conduct relating to CIS and to carry out on-site inspections
- The regulatory authority must have sufficient powers to protect investors' interests by way of revoking licenses, issuing compliance or cease and desist orders, freezing assets, stopping distributions etc.
- The regime may provide for third party supervision, such as imposing requirements on auditors and other parties involved in CIS operations.

Virtually all of these elements are found in the regulatory and supervisory framework for unit trust and mutual fund regulation established under the Fin*ancial Services Commission Act, 2001*, the *Unit Trusts Act*, the *Securities Act* and the regulations made under that Act, including the *Securities (Mutual Funds) Regulations, 1999*.

### 3. Observations on Supervisory Framework

The trend towards convergence of the deposit-taking financial institutions and securities dealers will create regulatory challenges for both the FSC and the BOJ. Deposit-taking institutions are typically subject to a higher degree of prudential regulation than securities dealers. By contrast, the latter are subject to a higher degree of market conduct regulation than banks, in the form of fit and proper standards, product regulation, qualification and licensing criteria and supervision of procedures.

A purely functional division of supervisory powers by activity is likely to result in overlap, confusion, conflicting requirements and could possibly jeopardize investors' interests. We believe a clear separation between deposit-taking activities and securities activities would be desirable, and the best way to achieve this would be by ensuring that these activities are carried out in separate companies in the financial group.

Clear rules will be required as regards capitalization at the holding company level and the operating financial institution level. In developing these rules, an over-arching principle should be to ensure that each company is adequately capitalized (without double counting) in a manner consistent with its primary functions. Accordingly, we believe regulatory capital should be held at the operating company level. This will best safeguard depositors and investors interests and will serve towards ensuring a level playing field among those that are part of a financial group and those that are not. This is fundamental to competition in the capital markets, which in turn results in innovation and efficiency.

We are concerned about the apparent absence of a clear demarcation between on-balance-sheet activities and off-balance-sheet activities of securities dealers and merchant banks. As a corollary to the separation of securities activities and deposit-taking activities into separate corporate entities, rules should be developed to ensure that legal and accounting policies and practices are consistent with customers' expectations as to the nature of their entitlements and that financial reports provided to regulators are meaningful in presenting a true picture of the claims against the institutions in question.

## V INDUSTRY OBSERVATIONS

Industry participants are justifiably proud of the fact that the industry has grown to the size that it has in the short period of time that it has; and this without any major investor losses as a result of governance and regulatory problems. They recognize the importance of ensuring that the public's expectations are and continue to be met in this respect. They have stressed the importance of there being the right regulatory environment, designed to support the integrity and trust upon which the industry is founded but freed of impediments such as regulatory

moratoria and cumbersome institutional arrangements that make it difficult and costly for the industry to develop and function as efficiently as it could.

A common theme in meetings with industry participants has been the difficulty of launching new products- in the case of unit trusts, as a result of a regulatory moratorium, and in the case of managed funds, as a result of legal uncertainties and constraints under existing securities legislation. Industry participants have pointed out the potential benefits that could flow to Jamaica by encouraging the development of a Jamaican-based investment fund service industry that has access to international markets and market participants on an open and transparent basis.

Among the themes that recurred most frequently in our industry consultations, we note the following:

- The mutual fund regulations recently adopted under the *Securities Act* are of limited use because Jamaican company law does not provide for a type of corporate vehicle that could operate under the regime contemplated by those regulations, given the need of an open-ended fund to redeem its securities on a regular and expedited basis;[12]

- The existing moratorium on unit trusts imposed by the Ministry of Finance is hurting the unit trusts as they have been unable to make any changes to their schemes to respond to market forces and investor demands for new (especially) medium-term investment vehicles;

- Prior to the unit trust moratorium, the regulator was unable to adequately serve the needs of the fund managers by reason of insufficient and inadequately trained resources to consider and approve new product offerings and changes to trust deeds, and to provide approvals required under existing legislation within an acceptable time frame;

- The requirements for institutional trustees for unit trusts and institutional custodians for mutual funds impose an unnecessary administrative and financial burden on fund operators. The trust business is in decline and trustees by and large do not provide the level of service needed to meet the needs of the funds. In particular, the T+3 redemption requirement is not responsive to market needs. Moreover, the trust companies are all part of financial groups that offer pooled fund investments that compete directly with independent dealer offerings. It would be desirable to find the intended safeguards through some other means;

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[12] This concern was raised in several meetings. However, we believe the most recent amendments to the *Securities Act* effectively deal with this problem. See below "Legal and Regulatory Framework- *Securities Act*.

- There is a pressing need for a book entry system for trading debt securities, and in particular government debt. Existing back office operations are costly and fraught with human and systemic risks (see below *"Systemic Risks"*). The industry will require government assistance or intervention to develop a mandatory book entry system, but this should be a priority;

- The regulatory and governance regimes applicable to different types of pooled funds should not result in different cost structures that confer an advantage on similar competing products over others. Concerns about a need for a "level playing field" arose in almost every industry meeting;

- The tax regime previously conferred an advantage on unit trusts over other pooled fund offerings. It is not clear to what extent this is still the case, but there is a clear desire that tax rules be harmonized to provide for equal treatment, similar to recent legislation governing long term savings accounts;

- There is strong investor demand for access to foreign funds, and this should be satisfied in the first instance by giving Jamaican securities dealers the ability to steer their clients to foreign funds on a "carrying dealer" basis rather than merely acting as a referring intermediary to a foreign dealer without any continuing responsibility to the client, as is presently the case;

- As a matter of fund governance, a requirement for independent directors or independent trust advisory boards (i.e. independent of the manager) such as is found in many mature markets is unlikely to function as intended because of the limited number of skilled individuals who are willing and available to serve in this capacity- and don't already have ties to the industry that would disqualify them;

- The industry would accept suitable risk-based capital requirements;

- There should be substantially more onerous requirements under the *Securities Act* to obtain a securities dealer license than for an investment advisor license, so as to limit those entitled to offer managed accounts to entities that are adequately qualified and capitalised;

- There is a need for uniform rules to regulate the calculation of fund performance data and valuations, so as to give investors the ability to make meaningful performance comparisons between different funds.

## VI SYSTEMIC RISKS

We have identified three main areas where we believe there exists serious systemic risks resulting from the institutional framework and market practices. These are

- Trading arrangements for Government debt securities
- Exposures of money market dealers to each other
- Maturity mis-match between the dealers' holdings of medium term LRS and funding thereof through short-term repurchase agreements with retail investors

Trading of GOJ debt securities, which comprises the major portion of the capital markets, is conducted in an unorganized OTC market. Physical delivery of securities is effected against delivery of uncertified cheques. As regards transactions between primary dealers on their own account, although clearing and settlement occurs on a same-day basis, settlement occurs by cheque rather than by netting of accounts at the BOJ. Since cheque clearance can take up to seven days, this exposes market participants to a number of risks, including everyday risk of loss as a result of human error, fraud, and a very serious risk of loss as a result of the insolvency of a purchasing dealer having received physical securities prior to insolvency and being unable to pay for them. There would appear to be two possible means of eliminating or at least mitigating these risks. These are

- to move as quickly as possible to a book-based system for debt securities, and
- as an interim measure, to develop mandatory trading rules for the OTC market, (similar to those which existed for the JSE prior to electronic trading) possibly through a securities dealers' SRO.

There are no mandatory standards governing dealers' exposures to each other, and this in a market where daily trading volumes are very high on account of the short-term nature of the major portion of funding for the market. By way of example, one dealer with funds under management of J$ 24 billion states its monthly trading volume in government and fixed income paper to be $ 47 billion, or approximately J$2 billion per day. A rough extrapolation to the entire market would indicate that the money market trades two times its market value per month or more or less 10% of its value per day. By comparison, the listed equity market turns over only 2% of its market capitalization *per year* !

In this context, it is imperative that clearance and settlement on a real time basis become the rule, and not the exception or that daily "end of cycle" settlement

with netting be developed in the market. Alternatively, and as an interim measure, dealers' exposures to each other should be subject to mandatory limitations, and all dealers should have mandatory secured commercial bank lines of credit to back up their settlement obligations. Unless netting is instituted, payment for securities against delivery should be by certified cheque.

The bulk of the money market is in the form of local registered stock. These LRS are funded by the dealers through repurchase agreements (repos) with investors (pooled and individual) on terms ranging generally from 8 days to not more than 90 days. With upwards of 25% of the stock of government medium term debt (or $J 44 billion) funded on this basis, there appears to be an enormous re-funding risk on the part of the dealers.[13] We have not examined this question in any detail but merely observe that it appears to create a significant systemic risk that could be very detrimental to investors in the event that dealers became unable to settle their repo obligations by reason of being unable to fund their LRS holdings. Put another way, the refunding risk for government debt appears to effectively lie with the market rather than with the government itself, and this is a significant risk in the absence of a developed medium-term market.

## VII THE NEED FOR A COMPREHENSIVE SCHEME OF COLLECTIVE INVESTMENT REGULATION

### 1. Basic Recommendation

As mentioned above, there are presently 8 unit trusts in existence managed by four management companies. We understand only two mutual funds have been registered under the MFR. Although the revised definition of mutual fund should at least have caught the attention of the large number of dealer-sponsored money market funds, apparently this has not happened.

As a result, other than the proportionately small amount invested in unit trusts, the bulk of Jamaican collective investment remains in funds and managed accounts that are only partially regulated, in the sense that they are offered by licensed securities dealers subject to FSC licensing and oversight. This is clearly insufficient. In our view, so long as there exists gaps in the applicable definitions, there will continue to be a largely unregulated component of the market. This creates distortions in the market place with respect to the regulated component, and more importantly, it withholds from investors some of the protections and safeguards they should be entitled to for this type of investment.

We recommend that all types of arrangements where money is managed for individuals on a collective basis, whether directly or indirectly, should be considered to be collective investment schemes and brought under a common regulatory structure. This does not mean that all requirements for CIS need be the same. The nature of the CIS product and the risks associated with it should

[13] Statistics on dealer and merchant bank holdings of LRS at March 31, 2001

be taken into account in developing the specific requirements associated with that type of fund. However, in our view, a uniform platform of core principles should apply to all collective investment funds, regardless of what kind of fund they are and who is offering them.

Similarly, given the functional division of responsibilities between the FSC and the BOJ, CIS regulation should take a functional approach rather than an institutional approach. The CIS regulatory requirements should apply equally to all industry participants managing or sponsoring collective investment funds, regardless of whether they are a commercial bank, a merchant bank, a securities dealer, a trust company or an insurance company.

Although the term “mutual fund” is the expression used in the *Securities Act* we believe that a more generic expression should replace “mutual fund in the MFR for a number of reasons. In our view, the term “collective investment fund” is best suited to the concept we have in mind as the foundation of the CIS regulatory structure. We prefer this expression because it will signal a new regulatory regime applicable to all collective investment funds. We propose therefore that the revised MFR become the *Collective Investment Fund Regulations.* For the time being, these regulations would continue to be fed by the definition of “mutual fund” in the *Securities Act*, but in due course that definition could be revised to reflect the new terminology.

The comprehensive regulatory scheme should apply, at the least, to
- unit trusts
- all other variable rate funds, other than variable rate insurance contracts and pension funds
- all fixed or guaranteed income money market funds, and
- any closed end funds that are launched, unless the securities of these funds are publicly traded on the JSE.

## 2. Developing a Comprehensive Definition

A definition of “mutual fund” was first introduced into the *Securities Act* by an amendment to that Act in 1996. The main requirements of the original definition were that:

a) a mutual fund had to be a corporation,
b) proceeds from the issue of securities by the corporation are pooled, and are managed and/or invested, and
c) the investor has a right of redemption whether or not at fixed periods.

The definition was amended in 2001 to remove the requirement for the fund itself to be in a corporate form, to add a requirement that there be a manager, and to add a provision allowing the Minister to prescribe any other arrangements as being mutual funds. The definition (as amended) contemplates redemption or re-

purchase by the person who owns, controls, supervises or operates a fund, rather than by the fund itself.

We have received conflicting views as to the scope of the amended definition, including industry views that it does not capture pooled funds that are managed under contract. Also, the exemption for "private trusts" may be much broader in its legal impact than might have been intended by the legislator. For example, would a trust form of closed end fund qualify as an exempt private trust? We understand that the Minister has not yet prescribed any additional types of schemes as mutual funds under his power in paragraph 17A (2) (b) of the *Securities Act*.

As a starting point, we recommend that the definition of mutual fund (or collective investment fund) should include all arrangements whereby the proceeds of securities issued to an investor are pooled with other investors' money, and (except for constant value funds) any change in the value of the investment is reflected in the redemption, re-purchase or encashment value of the securities. The following would reflect these concepts:

> "collective investment scheme" means an arrangement that allows the holder of a security to receive on demand, or within a fixed or specified period after demand, or on a fixed or pre-determinable date, an amount computed by reference to the value of a proportionate share in the net assets represented by the security, or where permitted by regulation, by reference to a fixed value.

This approach would not be intended to include accounts where funds are invested in specified securities for an individual investor so long as certain conditions were met. These conditions should include a requirement that the specific security be identified, that it be held in trust by the dealer for his client, and (where applicable) that the client receive copies of all disclosure documents relating to the security under the *Securities Act,* the *Companies* Act and any applicable JSE rules.

As an interim measure prior to amending the *Securities Act* in order to broaden the definition of mutual fund or replace it by a definition of "collective investment fund" as suggested above, the new definition could be prescribed by Ministerial power as contemplated in paragraph 17 (2) (b) of the *Securities Act.*

### 3. <u>Participations</u>

We have considered the situation where client funds along with the funds of other clients are invested in an identified security or financial instrument by way of what is essentially a "participation". One could argue that this is a pooled investment. However, in our view it differs from a pooled investment in that each investor receives a security representing ownership of an identified share of the

underlying financial asset, as opposed to a security that represents an ownership interest in, or the value of, a fund of assets. As long as this type of investment is identified as a participation in a specific financial instrument and meets the above requirements regarding being held in trust and disclosure, in our view, it should not be treated as a collective investment for regulatory purposes. As long as the regulatory scheme essentially protects the client investor from dealer risks, the risks in the participation would be the same as the risks in the underlying instrument. Accordingly, the rules governing and regulating dealers combined with the primary and continuous disclosure requirements (if any) applicable to the underlying instrument and its issuer should provide adequate investor protection for this type of account. Our inclination is that it is not necessary to regulate these accounts as collective investments, so long as they fall within the definition of "securities" under the *Securities Act* and are either subject to the rules governing primary distribution or in certain cases, are exempted.

In defining collective investment fund it will be necessary to develop exclusions to permit managed accounts and participations in specific securities to be exempted from the MFR as contemplated above.

### 4. Fixed or Guaranteed Income Funds

A large part of the capital market is made up of money market funds that are described as fixed income funds or guaranteed income funds. The defining feature of these funds is that they are offered at a constant net asset value, and fluctuations in price are reflected on income account. The redemption of these securities on a constant value basis creates a perception among investors that the funds are guaranteed as to principal and are as secure as a direct investment in the underlying government securities. Promotional material relating to these funds underscores the "security" or low risk aspect.

The fundamental question is whether the practice of allowing any fund to issue and redeem its units at a fixed price should be permitted. If so, then what rules should apply to ensure that the fund manager in fact maintains the fund at a constant net asset value? Finally, what type of disclosure is required to ensure that investors are made aware of, and are not misled, as to the nature and security of their investment?

Generally, if i) a fund is invested in government securities, ii) the maturity of the portfolio is very short, iii) income is distributed daily and iv) all transactions are on income account, the fund should be able to maintain a constant net asset value. The problem with many of the fixed or guaranteed income funds currently being offered is that they hold medium term debt obligations (mainly LRS) but sell and redeem units at a fixed price even though the cost and market value of the portfolio might not be the same. Moreover, it is not clear that these funds record all transactions on income account. Some may carry capital gains and losses that would affect the amount available on a full distribution of the fund. On a

liquidation basis, there is no guarantee that the net asset value of the fund would be the same as, or greater than, the fixed redemption price of all securities issued.

The problems involved in maintaining a constant net asset value could lead to the conclusion that this practice should be discontinued. However, there is obviously strong investor demand for short term investments offering secure income and a guaranteed redemption price. Given the importance of these funds in the island's capital market and the fundamental role of the offering dealers in the distribution of and market for government securities, we believe that attention should be focused on how to ensure that the constant net asset value and the actual value remain the same. Stated another way, the regulatory challenge is to establish appropriate rules in order to ensure that the funds are in fact consistent with investor expectations. A number of extremely complex questions can arise in this respect, and in many cases there is no absolutely right or wrong answer. This is an area that merits serious consideration by the FSC, BOJ and the industry, that is beyond the scope of this consultancy.

However, our preliminary observations, and some matters for consideration in follow up work, are as follows.

Ideally, the term to maturity of the portfolio on a dollar weighted average basis should not exceed 90 days and all portfolio securities should mature within 365 days. This type of formula would be consistent with rules in both Canada and the United States that allow money market funds to be sold on a constant value basis.

The more difficult question is how to accommodate LRS. We don't purport to have a ready answer, but we do have a few observations. As noted above, the government's re-financing risk has been largely shifted to the dealer community and ultimately to individual investors in money market funds. The government issues medium term debt but the market operates on a short-term basis. It seems to us that anything short of a BOJ repo facility for LRS at least equal to the value of the LRS (or other medium term securities) in a fund, would be insufficient to provide investors the security as to principal that they expect. Certainly the manager's commitment to repo from the fund would not be sufficient to meet investor expectations unless capital and liquidity requirements were increased to levels that are probably unacceptable. Reliance on the general liquidity of the market does not address the concerns about the fluctuations in the actual value of the portfolio. Thus, we conclude that LRS should only be treated as short term for money market fund purposes if there is a repo in place with a counter party of equal credit to the issuer.

Even if the portfolio of a fund meets our proposed short term maturity requirements, the value of the portfolio nevertheless may fluctuate from constant value and without corrective action by the manager, the fluctuations could be

significant. To address this concern, we would suggest that the following rules be considered as the starting point for constant value funds:

a) The portfolio should be marked-to-market at least once a week, and immediately if the BOJ reverse repo rate is changed.
b) If the market value deviates more than an agreed percentage from constant value (perhaps somewhere between 0.3% and 0.5%) the manager should be required to take immediate corrective action to eliminate the deviation.
c) The manager's obligations to make capital contributions or to re-purchase assets or implement other corrective action should be backed by adequate capital which is specifically allocated for this purpose and is not counted for any other purpose. "Adequate capital" might be 100% or more of the maximum reasonably anticipated potential deviation that could occur before the rules in a) and b) above would require corrective action.
d) No units or other securities of the fund should be permitted to be issued or redeemed at any time that the net asset value is below the constant value deviation threshold (say 0.3%) until the corrective action has been implemented.
e) A standardized compounding period (say 7 days) should be agreed upon and implemented in order to provide a uniform basis on which investors can compare yields between funds.
f) All gains and losses in a fund should be on income account i.e. net realized capital gains and losses should not be included in calculating yield.
g) Fund assets must be restricted to GOJ securities and cash in an unrelated licensed financial institution.
h) Use of derivatives in the fund should be prohibited.
i) Disclosure documents should prominently caution investors that principal is not guaranteed and is not covered by deposit insurance.

We are not recommending that constant value funds be exempted from any of the registration, disclosure and compliance requirements applicable to any other CIS. However, as long as adequate rules are developed to maintain any value deviation within an acceptable range, we believe the practice of offering the funds at a fixed redemption price should be permitted to continue. In our view, only money market funds that comply with these rules should be permitted to operate on a fixed redemption price basis.

## 5. <u>Closed-End Funds</u>

Our proposed definition of collective investment scheme would exclude closed-end funds which are JSE listed because these would be regulated as ordinary issuers of securities. However, the question of closed-end funds should be considered in the context of revising the MFR. A sub-set of specific rules for

closed-end funds as well as certain exceptions to open-end fund general rules may be desirable.

## VIII FUND STRUCTURES

Investment fund structures and governance are closely related. In many jurisdictions, governance mechanisms are a function of the mandated form of fund structure. In this section, we deal with fund structures. We conclude that a flexible approach would be the most practical for Jamaica given that different fund structures already exist, and the probability that foreign corporate form funds are likely to eventually register in Jamaica.

### 1. Existing Fund Structures

As noted above, the UTA contemplates a trust structure of collective investment. The fund is legally a trust and its assets are held by a licensed trust company, which must be independent of the fund manager.

The *Securities Act* definition of “mutual fund” appears to be permissive as to fund structure, although the MFR continue to contemplate a corporate structure. In practice, there are no local corporate mutual funds operating in Jamaica. We were told this is because of the absence of “investment company” legislation that permits redemption of shares without meeting normal company law requirements for share redemptions. We are told it would not be feasible to operate a corporate mutual fund under the existing provisions of the *Companies Act.*
The money market funds are structured mainly on a contractual basis, and probably include an implied trust between the manager and the fund itself, such that the fund assets would not be considered to be assets of the manager, although we understand that in some cases the necessary formalities to ensure a legal separation of assets between the fund and its manager were not carried out when the fund was organized, and in other cases these funds actually appear on the dealer’s balance sheet.

In most parts of the world, mutual funds tend to take one of two basic forms: a corporate form or a contractual form (including a trust form, which is a variant of the contractual model). The most significant difference between these two types of structures is that in the corporate form the fund is a separate legal entity organized as a corporation while in the contractual form the fund is a relationship (in the case of a trust, a relationship among the trustee and the beneficiaries) and is not a separate legal entity unless applicable legislation makes it one. For example, in subsection 1(1) of the *Securities Act* (Ontario) the definition of “person” includes a trust and therefore under Ontario securities law a mutual fund trust is treated as a separate legal entity. The corresponding section of the *Securities Act* (Jamaica) does not define “person” so it is unclear whether contractual form collective investment funds would be considered as separate legal entities for securities laws purposes. We think they should be, as this is the

most effective way of ensuring the legal separation of assets between the fund and its manager.

The corporate model is used in the United States, although a U.S. mutual fund can be either a corporation or a trust. The *Investment Company Act of 1940* and business trust legislation in some of the states treat investment trusts as if they were corporations, such that all US mutual funds rely heavily on corporate law principles and the responsibilities and duties of directors as part of their governance regime. Canada, Hong Kong and the United Kingdom permit the use of both the corporate and the contractual form (in which mutual funds take the form of trusts).

The trust or *contractual form* (as it is usually referred to) offers a number of practical advantages. There are usually minimal legal restrictions governing the content of trust deeds. This leaves investment fund organizers with a lot of flexibility as to the actual provisions of the trust deed. By contrast, investment funds that are structured as corporations are subject to extensive statutory provisions contained in corporate legislation, as well as a large body of law applicable to corporations. Also, flow-through treatment under tax legislation that is provided to trusts is generally not available to corporations unless special legislation is adopted. It should be pointed out that the average investor is probably unaware of the differences between a trust and a corporation. Where a trust form is used, there should be more extensive disclosure of investor rights to address this fact. This is discussed elsewhere in this report in the section on "Disclosure".

We recommend that the MFR should to be permissive as to the form of Jamaican investment funds. Given the permissiveness of the *Securities Act* definition of "mutual fund", the MFR should explicitly recognize that funds can be in a contractual or corporate form, and those provisions that clearly contemplate a corporation should be revised accordingly. This would be a relatively simple exercise. We also recommend adding a provision in the MFR to the effect that for purposes of the MFR and the *Securities Act*, each local mutual fund is deemed to be an issuer as defined in subsection 1 (1) of the *Securities Act*, regardless of the legal form of the fund.

As a regulated issuer, each investment fund would be subject to the general scheme of regulation under the *Securities Act*. Accordingly, provisions of general application relating to primary distribution, continuous disclosure, insider trading, etc. would not have to be repeated in the MFR. We also recommend that an additional provision be added to the MFR to require that regardless of the form of the fund, the assets of the fund shall at all times be held in a manner that evidences a legal separation from the assets of the manager.

## IX FUND GOVERNANCE

Fund governance refers to the mechanisms that are in place to ensure that someone has the responsibility of looking after the interests of investors. It is not clear in law that the fund manager has a legal obligation to put the interests of its sponsored investment funds ahead of all other interests. (It is noteworthy, however, that subsection 25 (1) of the MFR requires the manager to *"manage the scheme in the exclusive interest of holders*"). In practice, investment fund managers are concerned about increasing market share and providing a return to their shareholders. Their focus cannot be exclusively on their obligations to their sponsored investment funds, regardless of legislative attempts to prescribe otherwise such as section 25 (1) of the MFR.

Each governance regime must in some manner allocate responsibility for overseeing the management of the mutual fund in order to ensure that the interests of investors guide the management of the fund. With regard to governance, we recommend a flexible approach that would let each fund choose its own governance regime as long as that structure includes either an independent committee of one type or another or alternatively an independent trustee as is presently the case with unit trusts. Within the framework of governance, we also deal with the question of conflicts of interest. Custodianship, which is often considered to be an important aspect of fund governance, is dealt with in a separate section of this report.

### 1. <u>Alternative Governance Regimes</u>

Governance regimes differ with respect to the extent to which reliance is placed on persons within the mutual fund complex to administer a system of internal controls, as opposed to the allocation of this oversight responsibility to outside regulators (either in government or in a self-regulatory organization). For example, in some jurisdictions regulatory approvals are required for the appointment of certain key parties to the mutual fund complex and the regulator plays a role in sanctioning certain core components of the arrangements between the parties, whereas in other countries these matters are left either to the discretion of an independent board or to the discretion of the manager.

In the United States, the oversight responsibility for the mutual fund is placed squarely on the shoulders of the fund directors, who are involved in most aspects of the fund. By contrast, in Japan the oversight responsibility rests mainly with the Financial Supervisory Agency which is the authority in charge of the supervision of mutual funds. In countries such as Australia, Canada, Hong Kong and the United Kingdom, the oversight roles of persons in the mutual fund complex (i.e. the trustees, custodians and directors, as applicable) are more limited than in the United States, but more active than in Japan. Within the Jamaican context, and based on our philosophical approach to this assignment, our inclination is to put as much as possible of the responsibility for good fund

governance on the fund complex. This is in keeping with our view that there is a need for better regulation, not more regulation and that the regulatory scheme should allow competitive forces to operate with minimal intervention.

Many countries require that "independence" be built into the structure and governance of investment funds by requiring an independent trustee or custodian i.e. a trustee (or custodian) that is not related in any way to the investment fund organization. The trustee or custodian is responsible for carrying out functions that cannot be delegated. Alternatively governance schemes require that funds have a specified percentage of directors who are independent of the manager[14]. Some regimes contain a combination of both requirements.

There are advantages and disadvantages to each type of governance model, which we will briefly summarise.

A. Corporate Trustee Independent of the Manager

*Advantages:*

- An independent trustee can act as an effective check on management.
- Reliance on an independent trustee, unlike reliance on independent directors, is consistent with the philosophy that the mutual fund is the method whereby the manager sells investment advice (rather than the mutual fund being a separate entity)
- If successfully implemented, the use of an independent trustee resolves the principal problems inherent in the separation of management from ownership in the context of mutual funds.

*Disadvantages:*

- Cost of implementation. (This issue also arises with independent directors of corporate style boards.)
- The selection of a trustee from the limited number of trust companies in Jamaica in order to ensure the trustee's competence and independence.
- Competitive anomalies. For example, decisions concerning the investment fund would be scrutinized by a trust company that could be affiliated with a competing financial group which offers its own family of funds.

[14] Independence is essentially a question of fact. However, for purposes of this report we would consider any person who is not an "associated person" of the manager or of any entity in a "group" of which the manager is a member, within the meaning of the Securities Act, to be independent of the manager.

- An independent trustee does not have a direct stake in the success of the enterprise. (This issue also arises, but to a lesser extent, with independent directors of corporate style boards.)

While in theory an independent trustee does not have divided loyalties, in practice this may not be the case if the manager has the power to appoint or terminate the trustee or determine its fees. Accordingly, it is not entirely correct to say that an independent trustee can always look out for the best interests of the investors of the fund without worrying about the manager's interests. One of the criticisms leveled at trustees by unit trust representatives is that they lacked motivation and responsiveness. Mandating an independent trustee requirement (except for funds which continue to call themselves "unit trusts") is unlikely to increase trustee responsiveness and efficiency. Australia has recently moved away from a manager and independent trustee governance model, having concluded that the dual entity structure of manager and independent trustee resulted in a displacement of responsibility and was an inefficient structure to promote compliance.

B. A board of directors, governors or trustees, (as the case may be) of each investment fund or of a group of funds, comprised of at least a majority of individuals who are independent of the manager

*Advantages:*

- This governance regime introduces independent supervision of the investment fund.

- This model of governance could easily be implemented by fund complexes (large and small, trust or corporation) in Jamaica and moreover, the MFR already contemplate that a mutual fund will have its own board of directors.

- The model can apply equally to a corporate or contractual (trust) form of investment fund.

*Disadvantages:*

- There may be some uncertainty today as to the role, responsibilities and liabilities of members of a board which is not a true corporate board and as to what they should be.

- Members of a board do not have a direct stake in the success of the fund, unless they are also security holders.

C. A corporate trustee which is not independent of the manager but which has a board of directors comprised of at least a majority of individuals who are independent of the manager

*Advantages:*

- The cost associated with this governance regime may be lower than the cost of having an independent corporate style board of directors of the fund itself because the trustee will already have a board of directors. However, it would be necessary for the trustee's board to include a majority of independent persons.

- This governance regime would introduce some independent supervision of the mutual fund.

- More generally, it would provide an incentive for trust companies to include independent directors on their boards, in keeping with universally-recognized principles of good corporate governance.

*Disadvantages:*

- The board of the trust company will have divided loyalties as between the investors of the mutual fund and the stakeholders of the manager – affiliated trustee. Practically it may be difficult for them to "switch hats" from being trustee directors to trustee and manager supervisors even if they are independent.

- The pool of independent candidates to choose from in obtaining a majority of independent directors may be limited.

- The members of the board of directors of the trustee would most likely be chosen and removed by the board of directors of the manager, which would not foster true independence.

## 2. The Case for a Flexible Approach

Based on our industry discussions during the Inception Mission, we are inclined to recommend an approach that would simply require that each investment fund or fund complex have at least one of the above-mentioned governance mechanisms. We caution that that this flexible approach does present a number of potential difficulties that should be considered, including the following:

- the public may be confused as to how the various governance systems will operate and perhaps even skeptical that the various fund governance models adequately respond to the reasons for adopting a governance system;

- it will not be easy for the FSC to monitor, compile empirical evidence and evaluate the efficacy of the various models;
- it will take longer to establish best practices if there are different models of investment fund governance;
- allowing various governance regimes may provide an incentive for investment fund organizations to search for the least onerous choice, rather than choosing a system of fund governance that best looks out for the interests of security holders; and
- in the event that the FSC later decides to mandate only one specific fund governance model, then the organizations that chose another model and which would then be required to switch over to the mandated model would suffer additional switchover expenses through no fault of their own.

Despite these potential difficulties, we believe the realities of the marketplace would make it extremely difficult to mandate a single structure (independent trustee or custodian) as is now the case under both the UTA and the MFR. The need for an independent custodian in the MFR was criticized by many in the industry with whom we spoke and the disadvantages associated with the regime were well articulated. One of the most compelling reasons in our view to provide for alternative choices of governance is the competitive distortion resulting from the fact that any “independent” trustee will be part of a competing financial group, and we question whether such a trustee would be as effective as a truly independent trustee. We are not sufficiently convinced that this is the case to recommend imposition of this regime across the board. Therefore, it is hard to make the case for an independent trustee/custodian, over the case for simply an appropriately licensed custodian, whether independent or not.

Another reality which should be considered is the fact that the unit trusts presently operate with independent trustees, and may wish to continue doing so. They may perceive that there are some advantages from a marketing perspective which are associated with the unit trust “brand”, which implies independent trusteeship. In our view, they should be able to maintain their existing governance structures. If one were to impose on them a requirement for an independent board they would then be more vigourously governed than funds which do not have independent trustees. There might also be over-lap between the responsibilities of the board and the trustee.

The formation of financial groups is likely to result in option C. being the preferred approach for sponsors that already have a trust company within the financial group. This trustee would fulfill the custodianship requirement of the MFR and would also be a part of its governance regime. We considered recommending a combination of either A. (independent trustee) or C. (captive trustee trust has a board with a majority of independent directors) but we are sensitive to industry

observations that this would tilt the playing field to the competitive disadvantage of sponsors who do not have an associated trust company, and it would not address their main complaint about referring business and providing confidential information to a competitor.

All other things being equal, we would strongly favour model B. (fund board with at least a majority of its members independent of the manager). This would be in keeping with international trends in the evolution of mutual fund governance regimes from trusteeship towards oversight by an independent board whose interests are truly aligned with those of the investor. Through the MFR, the board could be given responsibilities similar to those of corporate directors. However, we are sensitive to the difficulty in recruiting adequately skilled and motivated independent members for these boards and we believe it may not be appropriate to prescribe this requirement across the board. We suggest that the FSC might wish to use its powers of moral suasion, where appropriate, towards influencing the industry to move towards this standard. It may also be desirable to include less onerous conflict of interest rules where an independent board exists.

As regards fund boards, we believe one of the criteria that might best ensure that the board members interests are aligned with those of the investors would be to impose a requirement that independent members have an investment in the related fund, and that this investment be more than nominal. However, this would be controversial and should be carefully considered before being acted upon.

The board should have similar duties and responsibilities to the fund as a corporate board has towards a corporation, including a fiduciary duty expressed in similar terms to that contained in section 174 of the *Companies Act, 1998.* Appendix C contains a set of recommendations as to how such a board could be structured and operate. Since the MFR already contemplates that mutual funds have a board of directors (on the basis that the MFR contemplate a corporate fund structure) the existing provisions in the MFR relating to directors would simply be adapted to make them applicable (optionally) to any fund structure.

## 3. Conflicts of Interest and Self-dealing

Because the interests of fund management and the interests of fund security holders are not always aligned, regulators have set up mechanisms to try to constrain a fund manager from putting its own interests or the interests of its affiliates ahead of those of the fund security holders. This goal has been accomplished through different types of legislative requirements. First, legislation can disallow certain specified related party transactions. Second, legislation can mandate that there be an independent review of the actions of management in order to provide a check on behalf of security holders. Third, legislation may provide that certain parties are subject to fiduciary duties of honesty, care and loyalty in exercising powers and carrying out duties in favour of security holders. Governance regimes of different jurisdictions use some or all of these techniques

in an attempt to minimize the potential for conflicts of interest between those managing the fund and those investing in it.

Prior to the emergence of financial groups, adequate protection against conflicts of interest was generally provided by a fairly prescriptive approach to defining prohibited transactions between a fund and its manager or related parties, and giving the regulatory authority the power to grant exemptions in appropriate circumstances.

However, within the context of financial groups or conglomerates, the opportunities for a manager-related party to provide services or financial products to a fund have become virtually unlimited. The number of potential transactions that would fall under the typical prohibitions of related party transactions has increased exponentially. Typically financial groups want to be released from prohibitions that prevent

- The execution of portfolio transactions on a principal basis through the related party,
- The purchase of securities offered or underwritten by the related party, and
- Related parties from buying and selling securities to and from each other.

Financial groups argue that investors in their proprietary funds are adversely affected by these restrictions and that the fiduciary standard of care, along with requirements that the transactions take place on an "arms length" basis (at market prices) should provide sufficient protection for investors.

Neither the UTA nor the MFR contain a scheme of prohibitions against related party transactions. In fact, in the financial groups with which we met during the Inception Mission, executing transactions through members of the group is a universal practice. The only provisions of the MFR or the *Securities Act* that might be described as relating to governance or conflicts of interest are as follows:

- The *Standards of Conduct* schedule contained in the Securities (Disclosure of Interest) Regulations, 1999. However, these regulations deal more with internal dealer governance, than with addressing conflicts of interest of the type that arise in relation to investment funds,
- Section 25 (1) of the MFR which requires the manager to manage the fund in the exclusive interest of the holders,
- Section 24 (1) of the MFR which prohibits the officers of a self-managed fund from dealing with the fund as principals, and
- Section 26 (1) of the MFR which permits the directors of a fund to remove the manager for insolvency or "good and sufficient" reason.

We recommend that this is an area where the MFR and the *Securities Act* should be made more explicit in prohibiting transactions in which conflicts of interest may arise. As a minimum, we would recommend the following:

*a.* A prohibition against a trade in securities by a person for his own account based on information he has concerning the investment program of an investment fund which he uses to his personal advantage for that trade (breach of this prohibition should be a penal offence under the *Securities Act).*

b. A prohibition against an investment fund buying securities of an issuer during primary distribution if the manager or a related person is underwriting the issue.

c. A prohibition against an investment fund investing in securities of an issuer of which a significant shareholder, partner, director, officer or employee of the manager (or a related person) is a significant shareholder, partner, director, officer or employee, unless that person does not participate in or influence investment decisions of the fund and does not have access to information concerning the fund's investment program.

d. A prohibition against trades by an investment fund in securities with the manager or a related person acting as principal, unless the securities are publicly traded and the trade takes place at the market price then in effect.

e. A fiduciary duty of care for the manager of investment funds and all persons retained to provide services to a fund, in terms similar to section 174 of the *Companies Act, 1998,* and a requirement that the manager indemnify the fund for any loss by reason of the failure of the manager (or any person or company retained by it to provide services to the fund) to discharge any of its responsibilities to the fund.

f. A prohibition against an investment fund bearing any portion of the cost of insurance to cover the liabilities of any person pursuant to the above provisions.

## 4. <u>Other Governance Issues</u>

We mention here a number of other governance issues on which we make recommendations elsewhere in this report, or on which we are not in a position to make recommendations by reason of having insufficient information as to actual practices currently taking place.

***Soft dollar transactions.*** This is a common practice in investment funds which refers to investment funds or managers receiving "off-setting" goods or services (or commission discounts that apply to fund and non-fund trades) for steering brokerage to one or more dealers. There is no universal consensus as to the extent to which this practice should be regulated, but there is a general discomfort with the idea that a fund manager or investment advisor may be receiving benefits by reason of steering fund business. However, it is acknowledged that the fund itself may also be receiving benefits (in the form of lower commissions) which it would not have if the steering didn't take place in the first instance. Perhaps, as a minimum, any arrangements whereby a fund agrees to steer all of its brokerage business to one or more dealers should be fully disclosed to the regulator and/or form part of mandatory disclosure. (See "The Disclosure System" below.)

***Investor rights.*** Investor rights, in addition to the "right to vote with one's feet", are often discussed in the context of corporate governance. We have not analyzed a scheme of investor rights suitable to Jamaica and we suggest this should form part of the follow-up work from this report. Some of the questions include:

- whether or not fund security holders should have the right to effect a change of manager (the MFR presently gave this right to the board of directors of a mutual fund);

- whether the investors should have the right to elect fund "directors" in a non-corporate structure, or to require certain other fundamental changes, or to rescind contracts to purchase fund securities within a statutory "cooling off" period.

Investor rights, whatever they are, should be clearly and prominently explained in disclosure documents.

***Accounting Standards and Role of Auditor.*** We received evidence of inconsistency in accounting standards and practices among market participants and funds. This is an area where follow-up work by FSC staff, in conjunction with the accounting profession, would be desirable. For our recommendations on standardizing performance data and disclosure to be truly meaningful, it would be necessary to ensure consistency of accounting practices, principles and standards. To the extent that some local practices do not comply with international standards for CIS accounting, these should be rectified. Two areas that merit particular attention because of their importance for investors are:

- computation of net asset value – not only to ensure comparability of performance information but also to ensure fairness among investors in a fund and between investors and the manager.

- accounting for realized and unrealized capital gains. In many jurisdictions these are not permitted to be included in calculating net investment income.

To the extent that accounting standards permit flexibility or alternative methods of accounting, in some areas it may be desirable for the FSC to prescribe a required approach in order to ensure consistency.

## X CUSTODIANSHIP AND OPERATIONAL MATTERS

Most mutual fund regimes impose a requirement for fund assets to be held by a custodian, and for assets that are not registered in the name of the fund to be registered in the name of the custodian. The role of the custodian is to protect the physical and legal integrity of the fund assets by separation of those assets from the assets of the manager, its associated entities and other funds, as well as the assets of the custodian itself. The provisions in the MFR relating to custodianship are generally consistent with these requirements and with custodianship provisions found in other jurisdictions.

### 1. Independent Custodian

Members of the industry suggested during the Inception Mission that, alternatively

- There should not be any requirement for a custodian, or
- There is no need for the custodian to be independent of the manager.

Those advocating that custodianship requirements be abolished argue that a) the unregulated funds and managed accounts have and continue to operate without any custodianship requirements and this has not caused any problems (in other words “if it ain’t broke don’t fix it”); b) it is anti-competitive to require funds to transfer business to a company which is part of a competing financial group; c) the number of qualified institutions is limited and their capabilities to efficiently execute fund transactions are inferior to those of the fund organizations themselves; and d) the requirement would add a cost burden which will have to be passed on to holders and is not justified by the perceived benefits.

While we can acknowledge the validity of some of these points, it is an almost universal feature of mutual fund regulation that fund assets are held by a custodian that is distinct from the fund itself. Accordingly, we would be failing in our duty to recommend a system which is consistent with international standards if we were to recommend abolishing the requirement for a custodian. Moreover, we believe that custodianship need not be an onerous requirement, that it serves a useful purpose in ensuring that the “back office” operates with procedural checks and balances and that it provides an additional layer of protection to investors. We note that in the functional separation of responsibilities between

the FSC and the BOJ, managers and funds will be supervised and regulated by the FSC (as will custodians in relation to their fund activities) but under the existing custodian qualifications contained in the MFR, only institutions licensed and supervised by the BOJ are qualified to act as custodians. We believe this adds an additional level of security to investors.

In maintaining a recommendation for custodianship, we repeat the first principle in our approach to this consultancy that "what is good for investors is good for the industry".

The MFR currently contains a requirement in section 18 that the custodian must be independent of the manager. We are not convinced that this is necessary, when taken together with:

- The fiduciary obligations of the fund manager (and the board we have recommended above under "Fund Governance")
- The eligibility requirements that must be met in order to act as a custodian or sub-custodian
- Our recommendation that the assets of a fund must be segregated from those of any other person or company
- Our recommendation that the assets of a fund must be registered in the name of the fund or the custodian
- Our recommendations below with respect to regular physical verification of fund securities, auditor compliance reports, commingling of cash and settlement and error correction.

Accordingly, if the above recommendations are implemented, it is our recommendation that section 18 of the MFR requiring that the custodian be independent be repealed, except for unit trusts.

The IOSCO principles require that the custodian be "functionally independent" of the operator of the CIS. We believe this is achieved by reason of the fact that the custodian is separately licensed and supervised by the BOJ, and by reason of our requirement under "Governance" that where a fund has a manager-related or "captive" trustee, the custodian must have a majority of independent directors whose role is to oversee that the custodian acts in the best interests of investors. In the context of financial groupings and conglomerates, independent custodians can be considered to be somewhat anachronistic.

## 2. <u>Custodian and Auditor Compliance Reports</u>

Certain jurisdictions that do not require independence on the part of the custodian add a "check and balance" to the system by requiring that the custodian certify to the regulator and the investors that it has complied with all requirements applicable to it in relation to the fund (the MFR contain such a provision) and that the custodian's auditors periodically provide a compliance

report with respect to the custodian's internal controls and operating procedures. During the Inception Mission, we discussed the addition of such a requirement with a member of the accounting profession and we understand that it would be feasible. Accordingly, we recommend that all custodianship and sub-custodianship agreements, regardless of whether the custodian is independent or not, contain a requirement that:

- Permit the auditors of the investment fund to have access to the books and records of the custodian and sub-custodian that pertain to the portfolio securities of the investment fund for purposes of their audit; and

- Require each custodian and sub-custodian to cause its auditors to provide a compliance report with respect to their requisite internal controls and operating procedures, at least once a year, and that the MFR require the custodian and sub-custodian to provide compliance certificates for the intervening quarterly periods. These reports should be filed with the FSC. Appendix D contains a sample of the custodian and auditor compliance reports.

### 3. <u>Physical Verification of Portfolio Securities</u>

In our discussions with members of the accounting profession during the Inception Mission, it was suggested that the custodian should be required to conduct a 100% physical count of portfolio securities on a quarterly basis and to reconcile its records with those of the fund. We believe this is an excellent idea and we therefore recommend that it be added to the custodian's duties set out in the MFR. We have made provision for the inclusion of a statement that this count has been effected (and a report on discrepancies) in the quarterly compliance certificate (Appendix D) that we recommend be provided by the custodian.

### 4. <u>Custodianship of Book-based Securities</u>

A number of systemic risks would be eliminated by the introduction of a book-based system for government debt securities. With respect to the assets of an investment fund that are "book-based", in our view there may not be a need to appoint a separate custodian to hold these assets for the fund. This would streamline processes, remove an intermediary that may no longer be necessary, lower costs and improve efficiency. In our view, where the investment fund manager is a clearing member of a self-regulatory organization (such as the JSE of an eventual industry-wide association) and is a member of the JCSD (or another organisation which ultimately operates a book-based system for debt securities) and of a related investor compensation fund, that member should be permitted to act as the custodian of an investment fund which it manages with respect to securities that are deposited in the book-based system.

According to this recommendation, existing JSE members could presently act as their own custodian for JCSD-traded securities. If a book-based system for debt securities is established, members of that system could act as their own custodian so long as the system included:

- an SRO for system members
- an investor compensation fund.

## 5. Commingling of Cash

The manner in which money received and paid out is handled by an investment fund can have a significant effect on reducing systemic risks, particularly those related to trading and settlement.

Money paid to managers or financial institutions on their behalf to invest in a fund is trust money that belongs to the fund whose securities the investor is purchasing. Money received from a fund by managers or financial institutions on their behalf for the payment of redemption proceeds to investors belongs to the investor. In both cases the money is impressed with a trust for the beneficiary, and should be held in a manner that reflects the trust.

Accordingly, we recommend that managers and financial institutions on their behalf should be required to segregate in a separate interest-bearing trust account the money received from investors for the purchase of securities of investment funds. The same rule would apply to money that is payable to investors on the redemption of securities of the fund. Section 36 of the *Securities Act* already introduces this concept to securities dealers, but this does not apply to financial institutions and would not apply to the funds themselves.

Financial institutions may regard the fact that they are subject to prudential norms and BOJ supervision as providing sufficient protection to investors. This argument misses the point. Funds received for the purchase or from the sale of fund securities are trust moneys and not deposits, and should be treated as such to ensure that the investors are protected against the claims of creditors of the financial institutions in the event of the insolvency of the financial institution.

These trust funds should be used only for the purpose of remitting to the fund or the investor, as the case may be, the purchase amount or redemption proceeds. The manager should not use any of the cash received to finance its own or any other operations in any way, and should only withdraw cash from a trust account for the purpose of

- remitting to the fund the amount or the net amount, to be invested in the securities of the fund;
- remitting redemption or distribution proceeds being paid on behalf of the mutual fund; or

- paying fees, charges and expenses that are payable by an investor in connection with the purchase or redemption of securities.

All interest earned on cash held in a trust account should be paid to holders at the time the redemption proceeds are paid to them, or to the fund to which the trust account pertains. Interest should be paid at a frequency aimed at ensuring that the fund benefits from the interest as soon as practicable. An appropriate payment frequency for trust fund interest payable to the fund should be established based on the rate at which interest accrues and the amount of interest involved. For redemptions these trust funds should bear interest from and including the date of receipt by the investor and vice-versa for purchases.

When making payments to a fund, we believe the manager should be entitled to make payments on a net basis. Accordingly, the manager should be entitled to offset proceeds of redemption or amounts held for distributions to be paid on behalf of the fund against amounts held in the trust account for investment in the fund.

The fund, through its auditors or other designated representatives, should be granted access to the books and records of the manager to verify compliance with these requirements.
A manager that deposits cash into a trust account should be required to

- advise the financial institution in writing at the time of the opening of the account that

  (i) the account is established for the purpose of holding client funds in trust,
  (ii) the account is to be labeled by the financial institution as a "trust account",
  (iii) the account is not to be accessed by any person other than authorized representatives of the manager, and
  (iv) cash in the trust account may not be used to cover shortfalls in any other accounts of the manager;

- ensure that the trust account bears interest at market rates; and

- ensure that any charges against the trust account are not paid or reimbursed out of the trust account.

## 6. <u>Settlement and Error Correction</u>

We were told during the Inception Mission that it often takes in excess of three days for custodians to remit proceeds of redemptions to the investor. In our view, any settlement delay beyond T+3 is unacceptable. This is not a matter on which it would be appropriate to make recommendations, but we are drawing attention

to it so that it might be addressed at an operational level. Eventually the matter should become of concern to regulators (both FSC and BOJ) if a solution is not affectively pursued. Perhaps financial institutions will become more motivated to increase their efficiency if our recommendation is accepted that interest accrues to the beneficiary as of and including the date on which the money is received by the financial institution to (but excluding) the date of payment.

We did not inquire specifically during the Inception Mission whether or not error correction procedures involved back pricing of orders. However, we strongly recommend that this not be permitted because of the potential abuse that can occur. Losses resulting from errors should always be allocated as between the manager and the custodian on the basis of pre-determined and relatively simple procedures, and should be corrected on a real time basis.
The question will undoubtedly arise as to whom, as between the manager and the fund, should bear losses, if any, from nsf cheques. The laws of some jurisdictions require that these losses be borne by the manager on the basis that this is simply a cost of doing business as a manager, and the manager is the one who has made the credit assessment on the investor.

## XI THE DISCLOSURE SYSTEM

Securities regulation throughout the world is founded on the fundamental principles of:

i. registration of persons who are permitted to deal with the public, and

ii. disclosure of material facts about issuers.

Based on the sampling of disclosure documents we have reviewed, we can say with confidence that the disclosure system is not working as effectively as it could. A large part of the problem is that the disclosure documents are not meaningful or relevant. The costs of all of this disclosure and associated mailing are high and are ultimately borne by investors.

The challenge is how to remedy the situation, particularly when disclosure and consent is the basis on which the system operates. This is particularly relevant in the case of investment funds, where there is a conflict of interest between the industry participant and the investors in the fund. “Buyer beware” is insufficient if the disclosure documents on which the buyer’s consent is based are not being read and understood by investors. Accordingly, our recommendations in this section are aimed at making disclosure relevant, meaningful, easily identifiable and readily accessible.

The focus of the disclosure rules should be to ensure that investment funds provide <u>investors</u> with disclosure documents that clearly and concisely state information that they should consider in connection with an investment decision

about the fund. We suggest two general approaches in order to achieve this result.

- First, these documents should be prepared using plain language and in a format that assists in readability and comprehension.

- Second, investors should receive disclosure documents that will be helpful to them.

We recommend the use of three documents by an investment fund (in addition to financial statements):

a) An industry generic basic education document that is given to all potential investors at the earliest time possible in the sales process;

b) A fund-specific base disclosure document which we call a Simplified Prospectus, which is given to all investors prior to the purchase; and

c) An Annual Information Form, which is available on request, that, together with the financial statements and the Simplified Prospectus, contains full, true and plain disclosure of all relevant facts pertaining to the investment fund.

## 1. <u>The Basic Education Document</u>

We recommend that a basic education document for investors in investment funds be prepared that would be:

- industry generic, and

- written in plain language.

This document would explain what an investment fund is, how it works and the basic regulatory requirements that affect all investment funds. The inclusion of this information in this document would eliminate the need to repeat it in the Simplified Prospectus or the Annual Information Form. It would therefore contribute to the clarity of those documents. A good example of the type of document we have in mind is the JSE's "Talking Simply About … " series. These documents are easy to read, simple and informative.

### a) Contents of the Basic Education Document for Investors

In addition to explaining what an investment fund is, how it works and the basic regulatory requirements that affect all investment funds, the basic education document would tell investors what they should expect to receive after they place their order for the purchase or sale of investment fund securities. It would contain

samples of confirmations and other standard forms with an explanation of how to read them and what to do if the investor does not receive them or has questions. It would explain that current valuations of investment funds are published in the newspapers and would explain the information that is given. The basic education document could contain:

(i) a glossary of the commonly used terms to assist investors in understanding the information contained in the basic education document as well as in the other disclosure documents;

(ii) basic information for the investor about how to set financial goals, determine the investor's tolerance for risk and set investment objectives so that these can be matched against proposed investments;

(iii) generic tax information about income and capital gains distributions and capital gains (or losses) on the disposition of securities;

(iv) generic information about alternative investments or financial products that might be considered as an alternative to investment funds.

**b) Delivery of the Basic Education Document**

The basic education document for investors would be required to be given to each investor by the sales representative at the earliest opportunity during the sales representative's initial meeting with the investor and in any event no later than the time that the investor's order is taken. This would provide the investor with the opportunity to have the benefit of the information contained in the basic education document as early as possible in the process of making his or her investment decision. In a perfect world, the investor should receive and have read the basic education document before receiving the Simplified Prospectus.

In addition to being available in written form, it would be desirable for the basic education document to be made available on audio tapes, video cassettes and on the Internet. The basic education document could also be made available in schools, libraries and in various offices including the offices of the FSC, the BOJ, the JSE etc. Every fund manager should be required to maintain a copy on its web site.

**c) Preparation of the Basic Education Document**

The basic education document for investors should be prepared primarily by the industry but with input and oversight by the FSC to ensure that it is comprehensive and unbiased. There should be a procedure for periodically reviewing and updating the information contained it.

## 2. Simplified Prospectus

### a) Form and Delivery of Simplified Prospectus

All investors in an investment fund should receive a Simplified Prospectus, which should be a clear concise document designed to provide the typical investor with the necessary information to permit him or her to make an informed investment decision.

The existing prospectus schedule in the MFR should be replaced by a new schedule providing detailed requirements as to the contents and format of a Simplified Prospectus. These requirements should:

- Be designed to ensure that a Simplified Prospectus is clear, concise, understandable and well-organized, and contains the most important information that an investor would consider in making an investment decision;
- Standardize, to some degree, the order in which information is presented, in order to ensure that investors may easily compare one investment fund with other funds;
- Prohibit the addition of information in the Simplified Prospectus not specifically required by the regulation, in order to prevent a Simplified Prospectus from expanding to a size that discourages an investor from reading it, and that obscures the most important information about the fund that should be considered by the investor;
- Not require any information which can generally be obtained elsewhere by the investor with reasonable effort, if the information is not relevant to the investor's investment decision.

### b) Contents of Simplified Prospectus

The main purpose of the Simplified Prospectus would be to answer the basic questions of:

- What kind of an investment fund is it?
- What are its specific goals, objectives, volatility and risk profile?
- How is it going to achieve what it wants to do?
- Who is going to give it advice and provide it with management and administrative services?

- How will these people be paid and what will it cost for these services?

- What conflicts of interest are there and how will my interests be protected?

Included with the information to be provided in the Simplified Prospectus would be a concise and easy to read statement of the investment objective and strategies of the investment fund. If these change, this would be required to be disclosed in an amendment. The Simplified Prospectus should also contain an outline of the risk profile of the investment fund and indicate the type of investor that the investment fund is suitable for. Risk management should also be discussed. It may be desirable to develop a standard format for certain aspects of the disclosure for the different types of funds.

Full details about the fees, charges and other expenses (including sales commissions and management fees) that will be charged to the investment fund and about those that will be charged directly to the investor should also be required. Examples of the effect of these fees, charges and expenses on a typical investment of say $J 100,000 at the end of a one year, three years and five years assuming a realistic annual return and redemption at the end of each period, would be useful in showing the impact of fees and charges.

In addition, summary financial information should be included covering a period that is the lesser of say five years or the life of the investment fund. The type of summary information would include information about the net asset value per unit or share at the beginning of the period, income from investment operations, distributions from net investment income, capital gains and return of capital, and net asset value per unit or share at the end of the period.

Consideration could be given to allowing total return information to be presented for the abovementioned period with a comparison of the investment fund's performance with the risk profile. However, portfolio return information should only be considered if standardisation of performance information is mandated by the MFR.

## 3. <u>Annual Information Form</u>

### a) Purpose of Annual Information Form

A supplemental disclosure document, the Annual Information Form, would be required to be filed with the FSC and provided to any person on request. The Annual Information Form would supplement the Simplified Prospectus and should be incorporated by reference into the Simplified Prospectus. The Annual Information would basically be an annual update of the investment fund’s initial registration.

Information contained in the related Simplified Prospectus should not be repeated in an Annual Information Form except as necessary to make the Annual Information Form comprehensible as an independent document. Generally speaking, the Annual Information Form would be intended to provide disclosure about different matters than those discussed in the Simplified Prospectus, such as information concerning the internal operations of the manager of the investment fund, which may be of assistance or interest to some investors, the media and the regulator.

The Annual Information Form would be designed to ensure that it is prepared like a Simplified Prospectus: in a clear manner that encourages investors to read it. Both documents should use plain language in a format that assists readability and comprehension.

### b) Contents of Annual Information Form

In addition to updating the fund's basic registration information, the Annual Information Form would contain a discussion and analysis by management of the operations of the investment fund. The type of information that would be included in this management discussion and analysis (MD&A) cannot be found in the disclosure documentation that is currently in use, but is likely to be very useful to analysts, the media and more sophisticated investors. MDA might include:

- information regarding portfolio management strategies, including who is managing the investment portfolio, how they are doing it, any changes that have been made in this respect, the performance of the investment fund in relation to any performance goals that have been set for the portfolio manager, the risk profile of the fund and variances from it;

- information concerning the extent to which investment decisions are made by particular individuals employed by a portfolio adviser, or by committee, and certain specified information about the individuals who are principally responsible for the investment portfolio of the investment fund;

- discussion of the investment fund's performance for the current year in comparison with the prior year's performance, focussed on the total return of the fund;

- comparison of the investment fund's performance with relevant benchmarks and an explanation why the benchmarks that have been chosen are appropriate;

- discussion and analysis of expenses with the significant components of expenses being highlighted and compared to the previous year with an analysis of changes;

- discussion of known trends, commitments, events and uncertainties that are reasonably expected to affect investment fund performance in the future should be addressed;
- a comparative analysis of the composition of the year-end investment portfolio and changes in portfolio mix from year to year;
- a discussion of how the investment portfolio composition relates to the investment fund's disclosed investment objectives;
- if the investment fund holds: (i) illiquid securities, or (ii) securities of companies where liquidity risk may exist, or (iii) large blocks of securities of other issuers where it would be difficult to dispose of the block at the market value attributed to the securities, this should be discussed;
- a discussion of the number of securities of the investment fund that have been sold and redeemed with an analysis of changes from the previous year;
- a discussion of the supervisory and compliance procedures that are in place to ensure conformity of transactions with: (i) the investment objectives, policies and restrictions of the investment fund, (ii) the provisions of the material contracts in respect of the investment fund, and (iii) the standard requirements regarding investment funds referred to in the basic education document for investors; if there have been any breaches in respect of these matters, the action that has been taken to remedy them and to guard against re-occurrence should be outlined;
- a discussion about how portfolio transactions for the investment fund have been handled including information about any principal broker;
- disclosure of related party transactions as discussed under “Fund Governance - Conflicts of Interest and Self-Dealing”.

## 4. <u>Financial Statements</u>

The MFR should require that the most recently filed audited financial statements, and any interim statements filed after those audited statements, will be provided upon request to any person or company requesting them. Like the Annual Information Form, these financial statements would be incorporated by reference into the Simplified Prospectus, but would not be delivered to investors unless requested.

## 5. Amendments

An amendment to an Annual Information Form and to a Simplified Prospectus should be filed whenever a material change occurs.

In this respect, the current definition of "material change" contained in the *Securities (Disclosure of Interest) Regulations, 1999* refers to a change in the business operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of such securities. In the case of an investment fund, its assets consist of marketable securities and the securities issued by the investment fund are valued at the net asset value of these marketable securities - i.e. the market value of the assets of the investment fund less the liabilities of the investment fund. It is therefore unlikely that the market price or value of the securities of an investment fund will be affected by any change in the business, operations or capital of the investment fund.

Accordingly, the definition of what should be considered to be a "material change" in relation to the affairs of an issuer that is an investment fund needs to be defined in a manner that is not based on criteria that are relevant to an investment fund. Examples of changes that might be considered to be material changes in the case of an investment fund include a change in the manager, custodian or auditor of an investment fund, a change in the fund's fundamental investment objectives, a merger of one fund with another, a change in the risk profile of an investment fund, and significant changes in fundamental contracts. A change in the portfolio advisor may or may not be considered material, depending on the circumstances.

## 6. Plain Language and Presentation

### a) Plain language

A Simplified Prospectus and Annual Information Form should be written in plain language, i.e. language that can be understood by a reasonably educated person without specialized knowledge, applying a reasonable effort. This would make disclosure documents easier to read, and therefore more widely read by investors than traditional prospectuses. The MFR might require that investment funds use the following plain language techniques in preparing their documents:

| | | |
|---|---|---|
| 1. | short sentences | avoiding superfluous words |
| 2. | definite, concrete, everyday language | avoiding legal or business jargon |
| 3. | using the active voice | avoiding abstractions by using more concrete terms or examples |

| 4. | organizing a document into clear, concise sections, paragraphs and sentences | avoiding reliance on glossaries and defined terms unless they facilitate understanding of the disclosure |
|---|---|---|
| 5. | using strong verbs | avoiding vague boilerplate wording |
| 6. | using personal pronouns to speak directly to the reader | avoiding excessive detail |
| 7. | using technical and business terms only when unavoidable and only if clear and concise explanations are provided for these terms | avoiding multiple negatives |

In the promotional material we reviewed during the Inception Mission, we encountered many examples of well written, concise, plain language documents. A good example is one of the large fund families that publishes a "Four Steps to Effective Money Management" series. The requirement for plain language should not be difficult to comply with.

**b) Presentation**

The formatting of a Simplified Prospectus and Annual Information Form can assist in readability and comprehension. We suggest that certain aspects of a Simplified Prospectus and Annual Information Form should be presented in a required format, requiring some information to be presented in the form of tables, charts or diagrams. Within these requirements, investment funds could have considerable flexibility in the format used for Simplified Prospectuses and Annual Information Forms. The formatting of documents can contribute to the ease with which the document can be read and understood. The MFR could require that investment funds use some or all of the following formatting techniques when preparing their documents:

- tabular or bulleted presentation of complex information
- maintaining white space on each page to lessen the density of the text
- reasonably-sized, easy-to-read typeface
- "question and answer" formats
- avoiding presenting blocks of text in upper-case or italicized letters
- avoiding full-justified margins.

**c) Format**

We suggest that both a Simplified Prospectus and an Annual Information Form should be required to use prescribed headings and sub-headings and present

them in the order mandated by the MFR. For sections for which no sub-heading is specified in the MFR, sub-headings could be included under the required headings, if it is so desired. The purpose of this recommendation is to encourage the standardization of presentation to assist investors comparing one fund with another.

## 7. Delivery of the Simplified Prospectus and Annual Information Form

All investors should have a Simplified Prospectus delivered in accordance with the requirements of the MFR. This delivery would typically take place at the time the investment is made. This would not require the delivery of the documents incorporated by reference into the Simplified Prospectus unless requested. However, an investment fund would be free to adopt a practice of routinely providing investors or potential investors with a Simplified Prospectus, Annual Information Form and financial statements if it so chooses. Following delivery of the Simplified Prospectus, mailing requirements would be minimal.

Investment Funds should be encouraged to make Simplified Prospectuses available to potential investors as soon as possible in the sales process, in advance of any requirements contained in the MFR, either directly or through dealers and others involved in selling investment fund securities to investors.

The MFR should also require investment funds to post their disclosure documents and standardized performance information on an “Investor Relations” section of their web sites, and to inform investors that they may use the investment fund's Internet sites and e-mail addresses to request further information and additional documents.

## 8. Delivery of Promotional Material

In our view, it is not necessary for the MFR to restrict the delivery of material such as promotional brochures or flyers with either of the Simplified Prospectus or the Annual Information Form, provided that this type of material is not included within, wrapped around, or attached or bound to, the Simplified Prospectus or Annual Information Form. The current requirement under the UTA that promotional material be approved by the regulator before being used should be abolished. A provision should be added to the MFR to say that if there is a discrepancy between any promotional material and a Simplified Prospectus, the latter will prevail. Promotional material should be delivered to the regulator within 30 days of first use and could occasionally be spot-checked on a selective basis. The use of misleading promotional material should give rise to penalties, thereby placing the onus on the manager rather than the regulator to ensure that the promotional material is accurate.

## 9. Client Statements

We are not recommending that investment funds be required to prepare and mail security holder statements because we understand that securities dealers have a separate obligation to issue statements to their clients providing summary portfolio information. Accordingly, we feel that it would be unnecessary for basically the same information to be mailed to an investor from two different sources. If we are incorrect in our assumption about dealer-generated client statements, then we would recommend some form of security holder statement to be mailed by investment funds, perhaps on an annual basis. It should be noted, however, that this recommendation is linked to our recommendation below about standardization of performance data and weekly disclosure in the press.

# XII INVESTMENT POLICIES AND RESTRICTIONS

## 1. Overview of Regulatory Approaches

There are generally speaking three different approaches to regulating risk in an investment portfolio:

- Prescribing a list of permitted investments, often accompanied by certain restrictions or quantitative requirements
- Prescribing diversification and liquidity requirements and concentration limitations, with or without specific restrictions
- Establishing a portfolio risk/prudent person approach.

The traditional list of permitted investments used to be typical of trustee, life insurance company and pension fund legislation. This approach is based on the theory that the risk of a portfolio is equal to the sum of the risks of the individual securities in the portfolio. However, in recent years many jurisdictions have moved from static lists towards a portfolio risk approach. This is based on a realization that portfolio risk is as much a function of the overall content as it is of the nature of specific securities. CIS regulatory schemes typically preserve some element of concentration restrictions and diversification standards. These can be imposed in conjunction with either a static list or a portfolio risk approach.

The UTA is silent on investment restrictions, but the standard trust deed employs what can best be described as the “permitted investment” approach, combined with quantitative restrictions. The MFR adopts the diversification approach. Section 33 of the MFR basically contains a 10% limitation on a fund’s assets being invested in securities of any one issuer, and a requirement that at least 70% of the fund be invested in readily marketable securities. There is no exception to the concentration limit for government securities, and no exception for cash in the marketable securities requirement. There is a need for at least

fine-tuning of this section, if only to allow the two exceptions noted above, and include a more specific liquidity requirement.

## 2. <u>The Case for Adopting a Portfolio Risk/Prudent Person Approach</u>

The prudent person approach moves management of risk from a task of obeying a list of restrictions in selecting individual assets to one of analyzing and developing the best portfolio within a set of risk constraints. In a prudent person regime, the manager would be held responsible for the outcome of the portfolio and not on the selection of individual assets. This approach enhances the ability of fund managers to produce products that suit the specific needs of security holders in terms of investment returns and risks.

A portfolio approach would obviate the need to set out a list of permitted investments and/or investment strategies. These are almost always out of date as soon as they are developed as new financial instruments and investment strategies are developed, largely as a result of competition in the market place which encourages innovation.

The benefits that can flow from the portfolio risk/prudent person approach include:

- Simplified Regulation: The elimination of a quantified list, and the need to monitor the list for regulatory compliance. The FSC would be free to focus on overall risk regulation rather than playing a constant game of “catch up” in terms of trying to understand and regulate new instruments.

- New Instruments and Increased Competition: Innovation in the financial markets would be increased by the elimination of an impediment to the development of new instruments. This would foster competition to develop more alternative investments. This in turn would result in more opportunities for diversification in fund portfolios and better matching of funds to fund purchaser needs (differentiation).

## 3. <u>The Case for Diversification and Liquidity Requirements, Concentration Restrictions and Specific Prohibitions</u>

We recommend an approach that moves away from the UTA’s permitted investment approach and the MFR’s diversification approach, towards a portfolio risk approach. Nevertheless, there are some relatively fundamental aspects of portfolio management that we believe could continue to be included in the MFR without detracting from the overall portfolio risk regulatory model. Some of these restrictions are already found in the standard trust deed under the UTA or in the MFR. Some (such as our proposed prohibition on real estate investments) are new and are likely to stimulate discussion and debate within the industry. Our list

of constraints would include:

- A concentration restriction of 10% of total fund assets being invested in the securities of any issuer, as is currently found in the MFR, with an exception for government securities.

- A control restriction preventing a fund from holding more than 10% of the voting securities of any issuer, (perhaps with suitable exceptions for funds that are described and marketed as strictly “venture” “start-up” or “development” funds and are clearly marketed as highly speculative).

- A prohibition against investment in real estate and mortgages, broadly defined.[15]

- A prohibition against investing in commodities, other than gold evidenced by an internationally recognized and tradable gold certificate.

- A specific liquidity requirement sufficient to handle estimated redemption obligations, calculated perhaps against the single largest month of redemptions. The liquidity requirement would be developed on a weighted average “days to liquidate” basis, and might look something like: 1 day- 5%; 5 days- 25%; 15 days- 50% and 30 days- 90%.

- A prohibition against a specified percentage of fund assets being invested in illiquid assets. The MFR suggest that the appropriate percentage is 30% of “readily marketable” securities. However, certain JSE listed securities, depending on the size of the holding, may not be readily marketable even if they fall within the definition of readily marketable in the MFR. Perhaps the definition of “readily marketable” could be fine-tuned to include considerations such as market capitalization of the issuer, rate of turnover of the stock, other exchanges on which a stock is traded, etc. Based on our proposal above for a liquidity requirement, our illiquidity percentage would be 10%. Perhaps something in the range of 10% to 15% would be appropriate, with 90 days being the time to liquidation benchmark.

## 4. <u>Implementation of Portfolio Risk Approach</u>

The portfolio risk/prudent person approach could be introduced into the MFR by placing a positive duty on the part of the board of directors of the manager to develop an investment plan that explicitly identifies allowable risks and expected

[15] Because of the speculative nature of real estate, exposure to real estate risk should only be provided in a fund that is subject to special rules, such as a REIT. Functional qualification of the fund manager to manage real estate should be included in the requirements for this type of fund, stringent conflict of interest rules for the procurement of services, and appropriate independent valuation rules should be included, among others.

returns reflecting inflationary expectations, the size (or ultimate size) of the portfolio, liquidity needs and security holder expectations, consistent with the fund's investment objectives as set out in its Simplified Prospectus. Such a provision might be drafted along the following lines:

> *Investment Plan: The board of directors of the management company shall establish, and each investment fund shall adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return consistent with the investment objectives of that fund.*

In exercising its overview responsibilities in respect of the investment plan, the board might adopt specific policies such as a requirement that the portfolio manager adhere to the plan, procedures for monitoring the portfolio, marking to market, reacting to changes in interest rates, credit exposure analysis and internal reporting through an escalation policy that takes matters up through the organization quickly, including to the board of directors where circumstances warrant. The individual or individuals actually involved in the day to day investment of the fund should be required to hold an advisor's license under the *Securities Act*, and ideally would have some other formal qualifications in portfolio investment and risk assessment.

Portfolio risk would become a key focus of disclosure documents- both the Simplified Prospectus and the MD&A in the Annual Information Form. Specifically, the Simplified Prospectus should include:

- a policy statement setting out the funds objectives in terms of risk and return
- an identification of the type of securities that the fund is entitled to invest in
- risk parameter estimates
- providing historical long term rates of return and individual year return information in the manner discussed below under "Fund Performance Information"
- providing information on historical and largest monthly redemption rates
- restricting claims that estimated future risk will be less than the actual historical levels of risk experienced by the fund.

Contents of MD&A in relation to portfolio risk and risk management are discussed above under "The Disclosure System – Annual Information Form".

## XIII FUND PERFORMANCE INFORMATION

Most funds that we encountered during the Inception Mission provide some historical performance information in their promotional material. Fixed and guaranteed income funds advertise yields and provide comparative information for yields of competing financial products, such as savings accounts. The newspapers also publish unit trust yield comparisons. The common denominator of all of this information is that none of it is comparable because there is no standard approach to calculating fund performance information.
Arguably, historical yield information for variable rate funds, and comparative yield information for constant value funds, are the most important pieces of information assessed by investors in choosing both the type of investment and the specific fund in which to invest. It is therefore important that this information be presented in a standardized and consistent manner that allows comparisons between different funds.

The industry is likely to argue that regulatory intervention in this area is not necessary. Their arguments might include the fact that deposit-taking institutions are not regulated in their calculations of deposit yields, that generally accepted accounting principles provide sufficient guidance, and generally there doesn't exist a problem that requires regulatory intervention. They would also argue that disclosure of net asset value calculation methodologies would be confusing and meaningless to investors. We certainly would agree with this latter point.

Some jurisdictions approach the matter of performance information by requiring mutual fund advertisements, sales communications and disclosure documents to contain warnings about the information. For example, the Ontario mutual fund rules require a warning as follows:

> *Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rate of return is the historical annual compounded total return including changes in share/unit value and reinvestment of all dividends and distributions and does not take into account sales, redemption distribution or optional charges payable by the security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.*

Generally speaking, prospective investors are very interested in historical performance information when they are selecting a fund. Once a fund is purchased, the focus of the security holder is almost entirely on net asset value per unit. We recommend that the method of calculation and presentation of performance data should be standardized, and the periodic calculation and publication of net asset value per unit should be mandated in the MFR. Rather than warning investors that the information might not present the whole picture,

we believe the starting point should be ensuring that this type of information is uniform in its preparation and presentation. What is most important about comparative information is the relativity between funds of different manager groups and between types of funds within the same group. We believe the standardization of information so as to permit relative comparison would be very helpful to potential investors.

With respect to performance data, standardization might include such things as:

- requiring that the performance data be presented consistently for the past 5, 3 and 1 periods, if used at all,
- the periods used end as of the end of the financial year of the fund so as to coincide with its annual financial statements, and
- for money market funds, the period should be the calendar week last ended before the advertisement is prepared, and having occurred not more than a reasonable period (say 45 days) before the advertisement is published.

The MFR or guidelines should provide some basic guidance in the calculation of the total return and net asset value of investment funds (other than money market funds) and for calculation the current and effective yields of money market funds. We also recommend that investment funds (other than money market funds) be required to provide a net asset value per unit calculation weekly to the financial press, and that money market funds provide yield calculations on the same frequency.

## XIV REGISTRATION AND RELATED MATTERS

The MFR give the regulator a fairly wide discretion in reviewing applications for registration of mutual funds and requiring all necessary information before granting registration. This section focuses on a few matters which arguably would be included within the broad discretion conferred on the Commission in the MFR, but which we would recommend should be dealt with specifically.

### 1. The Registrant

The MFR are not clear about who is the registrant i.e. whether it is the prospective fund, the prospective fund manager or an “applicant”, and whether the applicant is one or more individuals who are sponsoring/will be operating the fund or indeed the entity (corporation or contractual trust) that will become the fund. In the course of revising the MFR, these matters should be sorted out. Perhaps it would be sufficient to introduce the concept of a “sponsor” in the MFR. Basically, “fit and proper” requirements should apply to the directors and officers of the sponsor of the fund, the manager of the fund and its key employees, as well as the future officers (if any) and directors of the fund itself.

## 2. Seed Capital

The MFR require that the “applicant” shall have contributed at least 40% of the net worth of the management company. We do not understand the rationale for this requirement. Rather, we believe a sponsor, who is independent of the manager, should be able to deal with an “arm’s length” manager that does not involve an equity investment by the sponsor in the manager. For example, a sponsor might have (or have a business plan for developing) a distribution network. In a joint venture with a securities dealer, the sponsor would bring investors to the fund, and the manager would bring investment advice. However, we do believe the sponsor should be required to provide seed capital to the fund in order to get it started, and to bear organization expenses.

In our view, seed capital should be sufficient to allow the fund to be up and running in accordance with its disclosed investment objectives from the first moment that it commences offering its units to the public. Seed capital should be locked in for a sufficient period to allow the fund to get going in an orderly and stable manner. The amount of seed capital is a matter that could be embodied in a directive or guideline of Commission, but any lock-in period should be included in the regulation itself.

## 3. Organization Expenses

The MFR should provide that the costs of establishing and organizing an investment fund must be borne by the sponsor or manager. These costs would include the cost of setting up the fund and preparing all of its contractual documentation, as well as the cost of obtaining the registration, which would include the cost of preparing the initial Simplified Prospectus and the initial Annual Information Form. An investment fund should be prohibited from assuming these costs or reimbursing the sponsor or manager for them.

Generally accepted accounting principles permit organization costs to be capitalized on the balance sheet of the entity involved and amortized over a period of time (say 5 years). This practice, if it were to be applied to investment funds, would result in the investment fund actually paying its organization expenses, only that payment would be deferred. Since this is the standard method of treating organization costs, we recommend that the practice be specifically prohibited in the MFR in order to avoid all doubt.

## 4. Assessment of Back Office Capabilities

The sponsor and manager should be required to demonstrate that the fund and its manager and custodian will have sufficient human and technical resources to carry out the necessary functions involved in its proposed activities. In the absence of an SRO that imposes back office requirements on its members, the onus will fall on the Commission to assess the capabilities of new entrants. The

sponsors should be required to demonstrate that they have the infrastructure in place to fulfill all of their administrative functions in a timely and secure manner. This would include order taking, order processing, segregating client funds in accordance with the trust requirements recommended above, handling account enquiries, issuing certificates and confirmations, and other administrative procedures.

Moreover, there should also be a demonstration of internal controls and the procedures to be applied in order to monitor compliance. Section 14 (d) (ii) of the MFR gets at this idea by requiring that the mutual fund appoint an officer responsible for compliance with the regulations. We agree with this approach, but would take it one step further at the outset by requiring the regulator to satisfy itself that adequate systems and procedures are in place so as to render non-compliance unlikely.

## XV CONCLUSION

The reaction of some who read this report may be that rather than recommending a revision of the existing regulatory scheme by revising and fine-tuning the MFR, we are calling for a totally new regime, based on overseas regulatory approaches and suggestions in reports of experts who have studied the industry in sophisticated highly-regulated markets. We acknowledge here that many of our recommendations reflect overseas (particularly Canadian) regulation, and much of the commentary reflects views of experts who have studied these issues in the context of regulating highly developed the North American markets, and not a developing capital market such as exists in Jamaica. [16] In anticipation of this potential skepticism, we wish to provide insight on our perspective.

During the Inception Mission we met extensively with regulators and representatives of the industry. It would have been tempting to reflect the views we heard in recommendations that gave the industry what it wanted and simply bridged the gap with regulators' concerns. Instead, we chose to formulate our recommendations on the basis of what we believe will best serve the typical Jamaican investor.

Accordingly, we developed our recommendations from the perspective of "what does the investor expect" when he or she buys an investment fund security.

We support our recommendation for a broader, open-ended definition of "collective investment scheme" by observing that the investor is not equipped to understand fine distinctions between differing investment products (such as constant value vs. variable) and does not anticipate that his or her rights and protections will vary depending on which investment product is selected.

We acknowledge the regulatory complexity in developing rules to ensure that fixed income or guaranteed funds maintain a constant value. Nevertheless, these funds constitute the major part of the capital market, investors like them, and they are beneficial to the economy. To us there was no alternative but to suggest rules, albeit complex, that would permit the continuation of these funds. The challenge is to put in safeguards to ensure that the "security" expected of these funds exists in fact.

As regards fund structure, governance and custodianship, the flexibility we recommend is based on the dual perspective that the investor doesn't really care, and flexibility is conducive to the development of new and better products. Moreover, the industry is expected to be based on integrity and trust. From our perspective it doesn't really matter what governance mechanisms are

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[16] See "Forward" for names of experts and organizations whose work has been reflected in our commentary and recommendations. See Appendix A for bibliography of sources consulted.

implemented, so long as they ensure that the investor's trust and expectation of integrity are safeguarded.

We anticipate our recommendations on re-vamping the disclosure system – re-focusing it away from the regulator and towards the investor – will attract the most immediate attention. We acknowledge the cost to the industry of preparing new plain language disclosure documents along the recommended format, and the effort required each year to prepare an Annual Information Form containing the information, discussion and analysis we suggest. We also acknowledge the regulatory burden that the review of these documents will entail for FSC staff. Skeptics may observe that if the new documents are not read by investors, a good part of this effort may be considered to have been wasted. With this, we disagree.

Fundamental to our approach on disclosure is the concept of informed consent, and after that "buyer beware". It may or may not be appropriate for Jamaica to shift the onus from the regulator "vetting" the investment product as protector of the investor, to the investor vetting the product himself or herself, based on mandated and understandable disclosure. We note, however, that prescriptive regulator oversight has had many costly failures in the past, both in Jamaica and elsewhere. Thus fundamentally the system will always contain a significant element of "buyer beware". Given this realty, our recommendation aimed at ensuring that the buyer's consent is informed would seem to justify the costs of implementation and on-going compliance. We note also for the benefit of the industry that there will be substantial cost savings associated with the elimination of the need to prepare and mail the documentation called for under the present regime.

Our most important recommendation, stated in the Introduction, is the need for follow-up work and our acknowledgement that better solutions may be developed. In this report we have provided a snapshot of the industry and its supervisory regime based on our observations over an intensive, but short, fact-finding mission. We hope our recommendations are responsive to the concerns arising from our observations.

We have no doubt that there exists the vision within the industry and leadership on the part of the FSC to deal meaningfully with these matters. This process could very well be evolutionary and consensual. It need not all happen at once if it is not feasible to do so. We hope that our work will provide the momentum for this process to get under way.

**Guy David**
September 2001

**Document No. 41411**

## APPENDIX A

**DOCUMENTS REVIEWED**

*1)* *Financial Services Commission Act,* 2001

*2)* *Securities Act*, 1993
Amendment Acts
a) 1996
b) 1999
c) 2001

*3)* Regulations made under the *Securities Act*

a) Licensing and Registration, 1996
b) Disclosure of Interest, 1999
c) Conduct of Business, 1999
d) Take-Overs and Mergers, 1999
e) Mutual Funds 1999
f) Central Securities Depository, 1999

*4)* *Unit Trusts Act, 1971*
Amendment Act, 2001

*5)* Regulations made under the *Unit Trusts Act*
a) Registration of Schemes, 1971
b) Books and Documents, 1973

6) Other (Unit Trusts)
a) Proposals for Amendments 1999 prepared by OSUT staff
b) Sample copies of Trust Deeds
i) Jamaica Investments (Capital Growth) Fund
ii) The Sigma Unit Trust Investment Growth Fund

7) IDB – Consultants report entitled “Regulation of Securities Markets, Intermediaries and Issuers: Jamaica Country Report and Policy Recommendation”

IMF Document - “Managed Funds”

(Preliminary Funds under Management as at September 30, 2000)

8) Information from the OSUT
Registered Unit Trusts. Data on:

- i) Size of Funds
- ii) Schemes
- iii) Managers, Trustees and Auditors Information
- iv) Summarized Balance Sheet Data for 1998 & 1999

9) Information from the Industry

- a) Samples of Managed Fund Contracts
  - i) DB&G Capital Management Certificate
  - ii) JMMB Fund Agreement
- b) Sample trust deeds governing unit trusts

10) The Economy

- a) Bank of Jamaica Annual Report, 2000
- b) Bank of Jamaica - Statistical Digest, March 2001
- c) Planning Institute of Jamaica - Economic And Social Survey -2000
- d) Economic Update Outlook (Quarterly survey published by the Planning Institute of Jamaica)
- e) Jamaica Stock exchange (1999 Year Book)

11) International and Foreign Reports

- a) Report on Investment Management - IOSCO, 1994
- b) Recommendations for Regulating Investment Funds in Canada ("The Stromberg Report") 1996 - Published by the Canadian Securities Administrators
- c) The Stromberg Report: An Industry Perspective - Prepared for the Canadian Securities Administrators by an industry steering group
- d) A Comparative Study of Individual Variable Insurance Contracts and Mutual Funds - Joint Working Group Report of Canadian Securities Administrators and Canadian Council of Insurance Regulators
- e) Making it Mutual: Aligning the Interests of Investors and Managers-Recommendations for a Mutual Fund Governance Regime for Canada June 2000, Published by the Canadian Securities Administrators

12) Web Sites

- a) International Organisation of Securities Commissions (IOSCO) - www.iosco.org/docs-public
- b) Jamaica Stock Exchange – www.jamstockex.com
- c) Ontario Securities Commission - www.osc.gov.on.ca

# APPENDIX B

## SUMMARY OF MEETINGS

### REGULATORS AND GOVERNMENT OFFICIALS

- **Steering Committee:** The steering committee for this consultancy includes the CEO of FSC, three representatives of the Securities Commission and two representatives of the OSUT. We met with the Steering Committee at the commencement of the Inception Mission and again at its conclusion.

- **FSC:** We met with Mr. Brian Wynter, CEO of FSC, at the commencement of the Inception Mission, and held a number of lengthy telephone conversations with him prior to, during and following the Inception Mission.

- **Office of the Superintendent of Insurance:** We met separately with representatives of the OSUT at the beginning of the Inception Mission, and again after having met with the Unit Trust management companies. During these meetings OSUT staff provided an overview of Unit Trust regulation, problems in the industry and regulatory challenges.

- **Securities Commission:** We held an initial meeting with Mr. A. Earl Melhado, Executive Director of the SC and two of his senior staff, to review SC's mandate, legislative framework and operations. A follow up meeting was held with Mr. George Roper, Director of Inspection and Examination. The thrust of this meeting included a review of recent legislative initiatives to strengthen the Securities Act, and a discussion of the structure of the securities industry.

- **Ministry of Finance:** We met with Ms. Bridgett Wilkes of the Ministry of Finance to brief her on Inception Mission activities, provide a preliminary overview of our findings and discuss practices and procedures related to primary distribution of Government securities.

- **Attorney General:** We met with Douglas Leyes, Assistant Solicitor General- Commercial Law, and with a member of his staff. The purpose of these meetings was to review the role of the Attorney General in the development of financial sector policy and legislation.

- **Bank of Jamaica:** We met with Helen McIntosh of the Bank of Jamaica to review issues relating to the structure of the debt capital market, market statistics and monetary and fiscal policy factors influencing the market.

**INDUSTRY**

Meetings were held with the following industry participants:

**Dealers, Merchant Banks and Unit Trust Managers**

- Capital Solutions Ltd. (William Massias)
- Barita Investments Ltd. (Rita Humphries-Lewin
- Capital Credit Financial Group (Andrew Cocking)
- Jamaica Money Market Brokers (Donna Duncan)
- Jamaica Unit Trust Services Limited (Oliver Chen)
- Dehring Bunting & Golding Ltd. (Peter Bunting and Clay Moodie)
- Sigma Unit Trust Managers (Sandra Shirley/designate)

**Advisors**

Meetings were held with the following industry advisors:

- Mark Golding, Attorney-At-Law, Hart, Muirhead, Fafta
- Fred Taft, Chartered Accountant, PricewaterhouseCoopers

Telephone consultation with Raphael Gordon, Chartered Accountant, KPMG

**Jamaica Stock Exchange**

Meeting and several telephone consultations with Wain Iton, General Manager

## APPENDIX C

### RECOMMENDED INVESTMENT FUND BOARD STRUCTURE

a) The board should consist of at least three individuals of whom at least a majority and preferably at least two-thirds are independent of the manager. The definition of what constitutes an “independent” member should be modeled on corporate governance principles.

b) There should be no restriction on the same individuals being on the boards of more than one or all of the funds in a fund complex.

c) The independent members of the board initially would be selected and appointed by the manager. Thereafter the independent members would be appointed by the full board (and not by the manager nor by the independent members alone) or in the case of a corporate mutual fund they would be elected by the fund’s shareholders as required by the fund’s governing corporate statute, in either case based upon the recommendations of a nominating committee composed of at least a majority of directors who are independent of the manager.

d) The fees of the independent members should be determined by the board, but in the first instance they could be established by the manager and the board jointly.

e) The fees of the independent members, as well as any additional expenses of having a board, could be paid either by the investment fund or by the manager.

f) The board, as well as the independent members as a separate group, should have the power to seek whatever professional advice and incur whatever expenses they reasonably require to carry out their duties, with the cost of such advice being borne either by the investment fund or by the manager. These expenses would be paid by the fund if the manager does not agree to pay them.

g) The independent members should hold a reasonable investment in each fund of which they are a board member.

h) The board should have the general responsibility to supervise the management of the business and affairs of the fund in order that decisions affecting the fund are made in the best interests of the security holders. The board need not have a detailed list of specific duties, but certain minimum responsibilities should be established. The minimum duties could include:

(i) evaluating the performance of the manager in various categories (including in providing an adequate level of service to security holders and in producing acceptable investment returns for the fund, before and after expenses, in comparison to appropriate benchmarks that take into account the fund's risk profile);

(ii) reviewing the financial statements of the investment fund;

(iii) checking that the fund is following its investment objectives;

(iv) monitoring the manager's compliance with the fund's portfolio risk management plan; and

(v) making decisions on behalf of an investment fund whenever a conflict of interest arises between the fund and any other party. In addition to the specified minimum duties, the board should have the flexibility to determine what else it should do to fulfill its broader general mandate. The board should not have the right to terminate the manager. The board should be given sufficient power to carry out its responsibilities.

i) Board members should have a fiduciary duty and standard of care similar to that of directors of a business corporation, as set out in Section 174 of the *Companies Act*, 1998.

j) Each board should have a chairman, who will be one of the independent members. The chairman should be responsible for managing the processes of the board. The chairman should monitor the fund on a regular basis and should be the key person who interacts with the manager on issues relating to the fund.

k) Each member should be entitled to be indemnified from the assets of the fund (and, if these are not sufficient, from the assets of the manager) for liabilities incurred while carrying out his or her duties, provided the board member has not fallen below the board's standard of care.

l) The board should be authorized to purchase appropriate liability insurance for the benefit of its members at the expense of the fund, but such insurance should not cover any liability resulting from not satisfying the board's standard of care.

m) If the board and the manager cannot agree on any issues, the board or the manager should report such matters to the FSC or to the security holders of the fund or, in appropriate circumstances, call a meeting of fund security holders to vote on the issues. To whom the report is made and whether a security holder meeting will be called will be a decision of the board or the manager based upon the nature of the matter in dispute. The FSC, however, should not be required to function as a mediator.

n) The manager should provide sufficient education programs to new board members and to all board members on an ongoing basis. Board members also should have the right to supplement these education programs by attending outside seminars (on the island) at the expense of the manager or, if the manager is unwilling to pay the costs, at the expense of the fund.

APPENDIX D

## APPENDIX B-1

### Compliance Report

TO: The Financial Services Commission
FROM: [Name of custodian]
RE: Compliance Report under the Securities (Mutual Funds) Regulations, 1999 (the "Regulations")

For the [financial quarter/year] ended [insert date], we hereby confirm that we have complied with the applicable requirements of sections 15 to 18 of the Regulations [except as follows:] [list exceptions, if any] with respect to our custodianship for the assets of [name of mutual fund]. This has included a physical count of all securities in our custody for [name of fund]. Attached hereto is a list of discrepancies resulting from such count. All such discrepancies have been rectified.

Signature: ______________________________
[Name and office of the person executing this report]

Date: ______________________________

## APPENDIX B-2

### Audit Report

TO: The Financial Services Commission
RE: Compliance Report under the Securities (Mutual Funds) Regulations, 1999 (the "Regulations")

For the year ended [insert date] we have audited [name of custodian's] report made under section • of the Regulations regarding its compliance for the year ended [insert date] with the applicable requirements of sections 15 to 18 of the Regulations.

Compliance with these requirements is the responsibility of the management of [name of custodian] (the "Custodian"). Our responsibility is to express an opinion on management's compliance report based on our audit. We conducted our audit in accordance with the standards for assurance engagements established by The Jamaican Institute of Chartered Accountants. Those standards require that we plan and perform an audit to obtain reasonable assurance as a basis for our opinion. Such an audit includes examining, on a test basis, evidence supporting the assertions in management's compliance report. In our opinion, the Custodian's report presents fairly, in all material respects, the Custodian's compliance for the year ended [insert date] with the applicable requirements of sections 15 to 18 of the Regulations. This report is provided solely for the purpose of assisting your discharging your responsibilities and should not be used for any other purpose.

Signature: ______________________________
[Name and office of the person executing this report]

Date: ______________________________

Chartered Accountants